

ISDA Collateral Committee

Forum for Industry Engagement on Collateral Management

Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls

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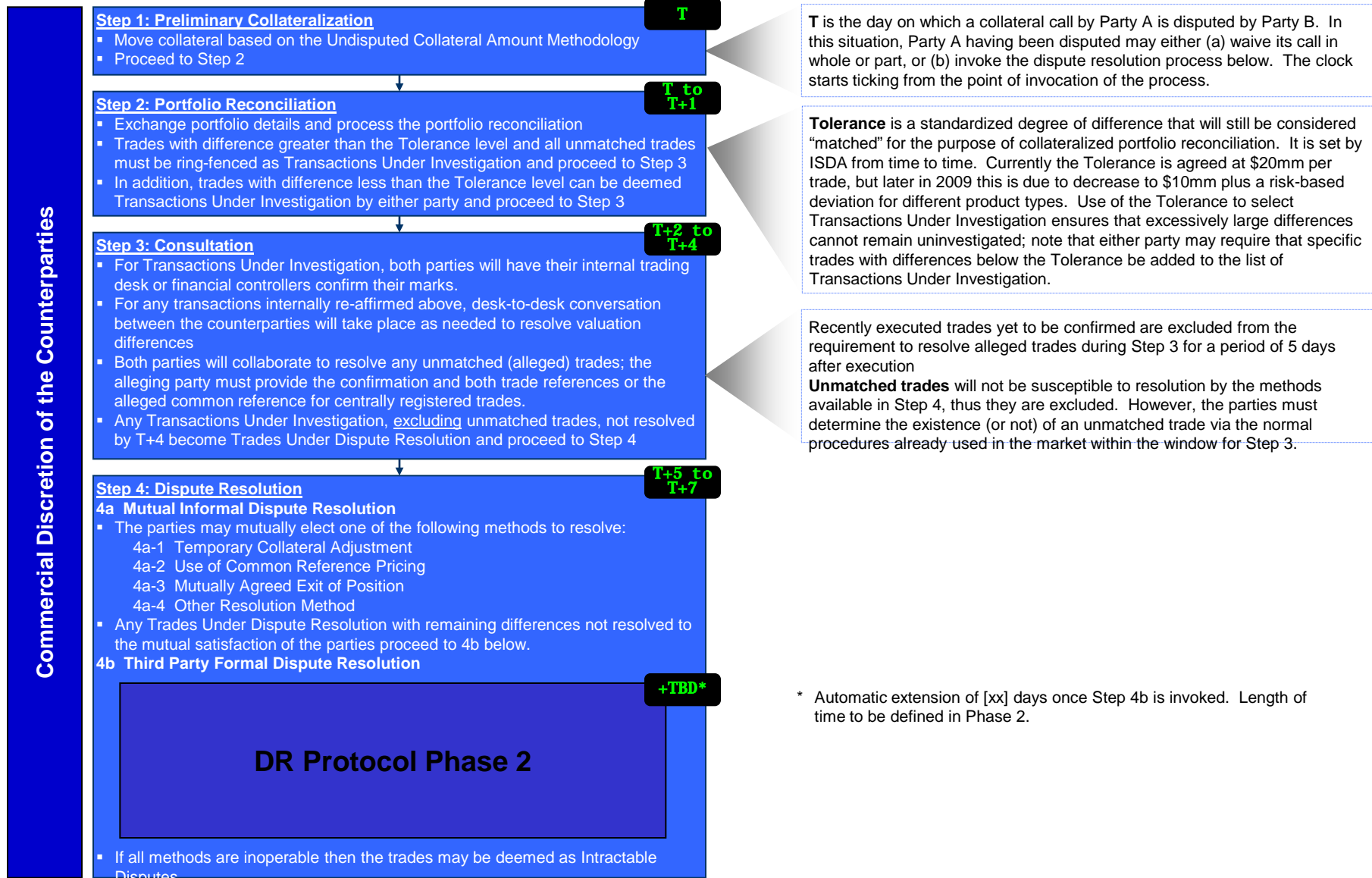
Introduction

- At the direction of ISDA's Board of Directors, the ISDA Collateral Committee in consultation with the ISDA Product Steering Committees and other industry associations has developed a proposal for the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the "DR Protocol")
- The purpose of this proposal is to provide a dispute resolution process for collateralized OTC derivatives that:
 - Achieves timely identification of the root causes of disputed collateral calls
 - Ensures the prompt movement of as much collateral as the parties can mutually agree
 - Provides the parties with a flexible range of methods to narrow and/or resolve their dispute to be consistent with their risk tolerance
 - Creates consistent and predictable process, timing and behavior in case of disputes across the market
 - Eliminates present uncertainties and delays that increase risk for the parties
- When operated in conjunction with enhanced regulatory disclosure in the case of hard-to-resolve disputes that we anticipate the supervisory community will request, the DR Protocol will bring to the market improved structure, transparency and probability that resolution of differences is ultimately effective.
- This document is an outline of the proposed 2009 ISDA Protocol for Resolution of Disputed Collateral calls and is being published for the purpose of soliciting comment from interested parties, in order to assist in the preparation of a final version for adoption. Details described herein are subject to amendment. A companion document, the Commentary to the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the "Commentary"), is being published simultaneously. It is recommended that the DR Protocol and the Commentary be read together.
- The proposal provides for a phased implementation of the DR Protocol that would permit significantly improved market practice in the near term coupled with continued development of certain more complex methods of dispute resolution. In summary:
 - Phase 1 (this document, published May 31, 2009 for comment) describes the over-arching framework for resolution of disputed margin calls
 - Phase 2 (to be published June 30, 2009 for comment) will provide additional methods for dealing with disputes involving complex, structured or illiquid transactions, which will inter-connect into the Phase 1 framework laid out here.
- When the DR Protocol has been thoroughly reviewed by market participants and subjected to a comment period, it is anticipated that final documentation will be drafted in accordance with the results of that review process.
- The comment period for Phase 1 of the DR Protocol is open now and closes on June 21, 2009. Comments should be directed to Julian Day and Nichole Framularo at ISDA (jday@isda.org, nframularo@isda.org)
- ISDA thanks all of its members and others who have contributed to the development of this proposal or who have provided comments on it.

General Terms and Conditions

- Commercial Discretion of the Counterparties. At all times the parties retain the ability to mutually contract as they wish subject to applicable law, and may exercise this right to cause a different timing or method of resolution from that set forth in the DR Protocol.
- No Obligation to Secure Credit Risk. Unless otherwise established by contract, official rules or statute, the parties to a privately-negotiated over-the-counter derivative transaction are not under an obligation to secure the associated credit risk of that transaction by means of collateral or other methods if they agree mutually to do otherwise.
- Timing.
 - The DR Protocol sets forth specified Standard Timings for each step. In setting these Standard Timings, it is necessary to balance the operational practicality of the time required to execute each step of the process in the ordinary course of business versus the desire from a risk management perspective to make all timings as short as possible. It also noted that the time required for each step in the DR Protocol may properly vary according to the size and complexity of the portfolio between the parties. Therefore the DR Protocol is based on the idea of Standard Timings which can be varied in certain circumstances. These circumstances may include (but are not limited to):
 - Disputed collateral calls caused by transaction differences that have already been thoroughly investigated, and may not therefore require the full Standard Timing to progress through the DR Protocol
 - Situations where especially complex transactions are being progressed through the DR Protocol but require additional time for investigation
 - Situations in which a credit event affecting one party is believed by the other party to be imminent, and therefore an expedited approach is called for.
 - Accordingly, the following timing adjustments are permitted:
 - Acceleration. Any step in the DR Protocol may be accelerated or bypassed either (a) by mutual consent of the parties or (b) by unilateral declaration of either party up to Step 4 which must then be completed.
 - Extension. Any step in the DR Protocol may be extended by mutual consent of the parties if they are actively engaged in the process and there is a reasonable expectation that resolution will result, subject to a maximum limit of 30 days for the overall process
 - The rationale behind the timings in the DR Protocol is the following. The Standard Timing is selected to be operationally feasible, if demanding, but not so long as to introduce excessive additional risk intervals that would adversely impact risk computations. Acceleration by mutual consent is designed to address situations where the parties have a good existing analysis of the portfolio differences and can proceed through the DR Protocol in a shorter timeframe. Acceleration by unilateral action is designed to address situations of imminent credit danger. Extension by mutual consent is designed to address situations where the parties need more time to investigate particularly complex situations. Finally, the overall limit of 30 days is designed to strike a balance between permitting enough time for the parties to exhaust all reasonable avenues of resolution and the desire of supervisors to be timely notified of intractable disputes.
 - If the parties reach T+30 without resolution, it is expected that they shall continue to engage in efforts to secure a resolution – i.e. it is not the case that on day 31 all discussions cease.
- Mutual Consent. Where the DR Protocol calls for mutual consent, it is anticipated that this would be given orally or via email. It is not intended that the obtaining of mutual consent be a laborious, time consuming or delaying process.
 - It is recommended that recorded lines be used for this purpose in case of any controversy
- Failure to Perform. If a party fails to perform the actions required in each step of the DR Protocol by the prescribed times (Standard Timings or modified times, if applicable), the other party can unilaterally decide to accelerate to the next step.
- Ability to Perform Portfolio Reconciliations. To be eligible to sign up for the DR Protocol, a party must have the necessary technical and human resources capability to perform portfolio reconciliations whenever required under the protocol, including the ability to appropriately investigate the results of such reconciliations

Overview of the DR Protocol



T is the day on which a collateral call by Party A is disputed by Party B. In this situation, Party A having been disputed may either (a) waive its call in whole or part, or (b) invoke the dispute resolution process below. The clock starts ticking from the point of invocation of the process.

Tolerance is a standardized degree of difference that will still be considered "matched" for the purpose of collateralized portfolio reconciliation. It is set by ISDA from time to time. Currently the Tolerance is agreed at \$20mm per trade, but later in 2009 this is due to decrease to \$10mm plus a risk-based deviation for different product types. Use of the Tolerance to select Transactions Under Investigation ensures that excessively large differences cannot remain uninvestigated; note that either party may require that specific trades with differences below the Tolerance be added to the list of Transactions Under Investigation.

Recently executed trades yet to be confirmed are excluded from the requirement to resolve alleged trades during Step 3 for a period of 5 days after execution

Unmatched trades will not be susceptible to resolution by the methods available in Step 4, thus they are excluded. However, the parties must determine the existence (or not) of an unmatched trade via the normal procedures already used in the market within the window for Step 3.

* Automatic extension of [xx] days once Step 4b is invoked. Length of time to be defined in Phase 2.

Steps 1, 2 and 3

Step 1 PRELIMINARY COLLATERALIZATION

- For a collateral call that is disputed on day T the calling party may either (a) waive its collateral call in whole or part or (b) invoke the following Dispute Resolution process.
- Depending on the terms of the CSA, a collateral call that is disputed on day T may have been issued on T or T-1.
- On day T, the parties agree any Undisputed Collateral Amount (“UCA”). This must be settled by the relevant party in accordance with the terms of the CSA.
- If both parties are calling each other simultaneously, there is no UCA.

Step 2 PORTFOLIO RECONCILIATION

- On T the parties are required to exchange portfolio information in electronic form. This includes, if in dispute, collateral asset, balance, interest amounts and valuation information.
- Portfolio information from the parties is reconciled (electronically or by other means as the parties consider appropriate) to identify trade or collateral asset level valuation differences.
 - A portfolio reconciliation may entail a full line by line, field by field matching process performed using technological means such as a portfolio reconciliation service or technology engine, or may be any other method that the parties agree accomplishes the same result of identifying and isolating the items contributing most significantly to the dispute.
- Using the appropriate Tolerance for each product type (as published by ISDA from time to time) the transactions with differences exceeding the Tolerance are identified and designated as Transactions Under Investigation. Either party may additionally designate other transactions whose differences do not exceed the Tolerance as Transactions Under Investigation or reduce the Tolerance to zero. If collateral assets, balances, interest amounts or valuations are in dispute then these are designated as Transactions Under Investigation. The list of Transactions Under Investigation must be identified by the end of T+1.
- It is possible that a dispute exists but no trades are designated as Transactions Under Investigation (ie no trades exceed the Tolerance and the parties do not so-designate any other trades with smaller differences). This could occur if a large portfolio contains many trades with individually small differences that in aggregate lead to a large difference. In

Step 3 CONSULTATION

- The parties are required to internally review all Transactions Under Investigation to verify their valuation. This may be done in whatever manner each party considers appropriate, but must include, if necessary, reference of the issue to the relevant trader or desk head.
- The following actions are not binding but indicate the type of process that each party should in good faith undertake during the Consultation step:
 - Investigation to detect incorrect matching of trades, data errors and other artifacts causing “false positive” reconciliation results
 - Review of golden records held in trade registries to assist matching trades
 - Referral of transactions to desks/controllers to validate marking curves and other model parameters are updated, and to confirm that marks are fresh and valid
- If anomalies are detected, recalculation of valuation and amendment of collateral calls by both parties occurs as necessary.
- Parties must consult between themselves at a trader-to-trader or desk head to desk head level to attempt to understand and resolve differences.
- Each party must identify the internal owner of each Transaction Under Investigation and facilitate a timely discussion with the relevant counterpart owner, exchanging contact information as may be appropriate.
- If anomalies are detected, the relevant party must recalculate its valuation and the collateral call shall be amended as necessary.
 - In the case of alleged trades or collateral assets not recognized by one party, the alleging party must provide confirmations, trade references or other supporting documentation; both parties must work to resolve differences due to alleged trades or collateral assets. These alleges must be resolved by T+4
 - All items entering Step 3 that remain unresolved by T+4 business days are designated as Transactions Under Dispute Resolution and move forward to Step 4a.

Step 4a - Mutual Informal Dispute Resolution

Method 4a-1 TEMPORARY COLLATERAL ADJUSTMENT

- Parties may elect to use this method if both agree to do so
- Objective is to agree adjustment(s) to the margin calculation in respect of certain specific transactions
- Adjustments are temporary - the parties agree their longevity, which may range from 1 day to 3 months unless reviewed and mutually extended or abbreviated
- Adjustments are applied to the collateral calculation, not the trade valuation. It is important to correctly characterize adjustments as temporary and applying to the collateral calculation not the valuation of the underlying transaction(s)
- Therefore the parties specifically acknowledge that Temporary Collateral Adjustments are not intended to amend the value attributed to any transaction by either party. It is intended that no P&L consequences should arise for either party as a result of this method being employed, and that results achieved via this method shall not automatically be deemed valid inputs to fair market value determination.
- Adjustment may follow the Mid Point Collateral Amount Methodology (equivalent to splitting the difference) or may be asymmetrical and thus yield a result closer to the opinion of one party, if both agree.
- This method specifically allows that each party to a dispute may receive only partial satisfaction of their claim, and that for the balance of the difference they may in effect agree to differ. This is entirely consistent with the idea that parties be free to transact on a fully, partially or un-collateralized basis in the privately negotiated derivatives market, within the boundaries of their prudential risk appetites.

Method 4a-2 COMMON REFERENCE PRICING

- Parties may elect to use this method if both agree to do so
- Common Reference Sources might include prices computed by clearing houses (e.g. TCC) but potentially also other sources provided by vendors.
- The parties mutually agree the source(s) to be used.
- Prices from these sources would be used instead of counterparties' proprietary mark-to-market calculations for the sole purpose of computing disputed collateral calls.
- The dispute would be avoided, since the collateral call would be re-computed based on common pricing
 - Arguably, such an approach does not avoid disputes, but rather recharacterizes them from being a difference between the values alleged by two counterparties (A and B) to instead being two independent differences, first between A and the Common Reference Source, and second between B and the Common Reference Source.

Method 4a-3 MUTUALLY AGREED EXIT OF POSITION

- Parties may elect to use this method if both agree to do so
- The parties may mutually agree to exit a disputed position, via several possible mechanisms.
- These include, but are not limited to:
 - Terminating one or more transactions, at a mutually agreed price.*
 - Assignment of the position by either party to a third party willing to take the trade, at a privately negotiated price between assignee and assignor.
 - Assignment of the position by both parties to an exchange or clearing house for which the position is eligible, at a price set by the clearing house.

** Clearly this would imply some agreement between the parties as to the price at which the termination would be executed. This may appear strange if the parties were unable to agree a price for collateralization purposes, but sometimes they may be more willing to agree an exit price and have certainty than have an on-going series of open-ended margin disputes over time.*

Method 4a-4 OTHER RESOLUTION METHOD

- Parties may elect to use this method if both agree to do so
- Consistent with the ability of the parties to contract subject to applicable law, and the inherent characteristics and conventions of the privately negotiated derivatives market, it is explicitly reserved that the parties may mutually agree any other method of resolution of a dispute existing between them.
- This includes, but is not limited to:
 - A compromise in the collateral requirement due, mutually determined in some other manner
 - A valuation mutually determined in some other manner
 - A mutual agreement to not collateralize some or all of the exposure between the parties, including exposure whose amount is uncertain or subject to dispute
 - A mutual agreement to disagree and to temporarily forbear exercise of other rights or remedies without prejudice to those rights
- It is strongly recommended that to the extent that any of these or other resolution methods lead to a partial solution with some measure of risk left uncovered by collateral, each party should consider appropriate risk hedges, reserves or other measures to economically protect against that open risk. It is noted that there will be a regulatory capital cost in relation to any unsecured risk under the Basel Capital Accord.

Regulatory Reporting and Notification

STATISTICAL REPORTING

- Firm managements will likely require statistical reporting about disputed margin calls and their resolution. It is also anticipated that supervisors will require some level of regular statistical reporting regarding transaction differences resolved through the DR protocol.
- Therefore a standard set of metrics is proposed to facilitate comparison of performance, both on a disclosed basis to each firm's regulator and (potentially) on an anonymous basis for the purpose of industry benchmarking.
- Firms should track (either themselves or via a vendor service) statistics around the Dispute Resolution process
 - Exact details of information to be captured and reported will be determined as part of implementation planning in respect of any industry – standard reporting required. It may include such data as the number of margin calls at different steps in the DR Protocol and statistics on the final method of disposition of disputes.
- Age is counted from the day T on which a margin call is disputed (the call may have been originally made on T or T-1). Each dispute event is separate for these purposes.

REGULATORY NOTIFICATION

- It is also anticipated that supervisors may require notification of any transactions that reach key points in the DR protocol. Any such requirement will properly be advised by supervisors and is noted here for information. Industry practitioners would be happy to discuss with the supervisory community the nature and timing of the disclosures that might be most appropriate and practical.

Implementation Considerations

- The DR Protocol Phase 1 will be subject of a comment period from publication on May 31, 2009 until June 19, 2009.
- In parallel, the proposal for Phase 2 will be developed. This is due for publication on June 30, 2009 and will again be followed by a comment period.
- Subsequent to the Phase 1 comment period closing, revisions will be made as appropriate and a final version published.
- An implementation timetable will be developed and agreed with supervisors
- As the work on Phase 2 is concluded and comments received, that too will be factored into the implementation timetable.
- It may be advantageous to roll out by industry segment, eg Fed 16 banks first, followed by other groups. A decision on this will be taken during the development of the implementation plan.
- One of the major elements of implementation will be the technical drafting of the detailed DR Protocol language.
- A further important element of implementation will be the nature of market adoption of the DR Protocol. It may be made available as an ISDA-sponsored protocol for adoption by firms during a defined adherence window; it may be provided as a standard-alone amendment for pairs of counterparties to bilaterally negotiate; it may be afforded the status of an industry best practice or guidance document. Each of these options has pros and cons and the determination of best adoption approach will be made after the consultation period as the implementation plan is devised.