

Dispute Resolution Commentary for Phase 1

1	General.....	1
2	Timing	2
3	Tolerance Levels	5
4	Unmatched Trades (Alleges).....	6
5	Step 4 - Mutual Informal Dispute Resolution	7
6	Implementation of Dispute Resolution	8
7	Dispute Resolution Structure and Points on Specific Steps.....	10
8	Metrics and Reporting	12
9	Operational Readiness	13
10	Additional Points to Incorporate.....	14
11	Q & A	17
12	Commentary Contributors.....	20
13	Document A. Fed March Update Letter - Portfolio Reconciliation Tolerance	20

The following document contains all the commentary received for the "Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls" published on June 2, 2009 and "Commentary for Phase 1 of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls" published on June 16, 2009

They are referred to as "Outline" and "Commentary" respectively for short below. Unless otherwise specified, the comments provided are related to the Outline.

1 General

- 1.1 As requested, we are providing feedback to ISDA on phase 1 of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls. As a significant participant in the commodity

markets, we are generally very supportive of the proposed methodology as outlined in the latest draft of the protocol. We believe that the draft proposals capture best practice as already seen on a bilateral basis between counterparties today and adopting this as market practice goes a long way towards achieving the intended purpose of the protocol i.e. to eliminate present uncertainties and delays that increase risk for the parties.

We also note that valuable work is already in progress to deliver phase 2 of the protocol and is expected to propose additional solutions for resolving issues around more complex collateral disputes such as those involving very illiquid positions

- 1.2 In general we support the proposal for a common framework for Phase I which clearly outlines the necessary steps each firm should follow and move through to investigate and reduce the number of collateral disputes.
- 1.3 As previously stated, it is our view that the liquid/illiquid or flow/structured product differentiation is not fully expressed in the current draft. The reason why we consider this to be of importance is it is our expectation that whilst the majority of liquid trade collateral disputes will be resolved in Phase 1, the majority of illiquid trade collateral disputes will fall through to Phase 2. Our assumption is that Phase 2 will address this and that the relevant wording to underline this issue will be inserted in the final version of the combined Protocol
- 1.4 We agree on the phase 1 of the protocol (from step 1 to step 4a) in its whole with the following comments and requirements ... (see above).
- 1.5 We are in broad agreement with the ISDA policy as stated in the DR Protocol Version F3 with the reservations expressed below ... (see above).
- 1.6 We broadly agree with the concept of the Phase 1 Dispute Resolution Protocol - additional process definition and transparency will help to create consistent expectations and behaviors among market participants, and provides greater clarity for regulators. However, there are three aspects of the proposal we would like to comment on, which relate to the entry criteria, timing and structure of the process ... (see above).

2 Timing

2.1 Timeline is too slow

Response: TBD

2.2 Specific Timelines should not be included in the protocol

- i) We would recommend that some caution is exercised in proceeding with a proposal which is formally tied to a very specific timeframe. As currently drafted, this timeframe can only be adjusted through the mutual consent of both parties and, without this agreement, it is intended that the other party can unilaterally decide to accelerate to the next step. We feel that this may not incentivise parties to mutually work together in the right way towards resolution of their dispute.
- ii) We also feel that it may be more appropriate to replace the specific timeframe in the protocol with an understanding that parties will work together commercially on a best endeavours basis to deliver each of the necessary steps in a timely manner, recognising that it is mutually beneficial to achieve resolution in as short a timeframe as possible. To this end, we feel that the protocol needs to be drafted in such a way that it does not penalise parties who are actively engaged in resolution of a dispute but, despite best efforts, are unable to meet the deadlines such as portfolio reconciliation within a day.

Response: TBD

2.3 Agree with Timelines as drafted in Phase 1

- i) While operationally aggressive, the tightening of timelines from a risk management perspective as they stand are an improvement from previous drafts. The ability to accelerate or extend a step with mutual consent gives flexibility to the differing scenarios and circumstances which may be faced in looking to resolve disputes. We agree with the 7 (working) day cycle for phase 1.

Response: TBD

2.4 The timing of the resolution process is reasonable, provided that adequate organisation and resources have been put in place.

Response: TBD

2.5 When one of the counterparty does not contribute actively to the dispute resolution, the protocol should propose a more explicit way to accelerate the process so that it becomes possible to reach directly the step 4.b

Response: TBD

2.6 Suggestions for the right to 'Accelerate'

- i) Whilst we understand the various positions in respect of "Acceleration" we feel that a unilateral right to accelerate through steps 1 to 3 is too extreme and re-iterate the view that steps 1 and 2 are basic requirements in any proper resolution of a collateral dispute. In respect of step 2 especially we fail to see how one could raise a viable dispute without going through this exercise as in the vast majority of cases such disputes almost invariably relate to portfolio collateral calls rather than single trade disputes. We therefore believe that steps 1 and 2 are prerequisites to identifying a single trade dispute. We realize that reconciliation is a collaborative process and therefore the ability of our counterparty to accelerate at any stage is variable and outside of our control. Therefore we suggest that wording indicating that any timeframe around acceleration must be predicated on it being "reasonable" and "practicable" with regard to the specific circumstances on the dispute. We suggest the following change:
- ii) "Acceleration. Any step.....(b) Step 3 may be accelerated or bypassed by unilateral declaration of each party except where a timeframe for consultation has already been mutually agreed".

Response: TBD

2.7 Right of Acceleration

- i) We do not think that the unilateral right to accelerate through steps 1 - 3 has been thought out carefully enough (see "General Terms and Conditions: Timing").
- ii) A balance needs to be struck between the need to compel parties to substantiate and verify the basis of the dispute and the need to allow a party to accelerate in circumstances where there is an imminent default or the subject matter of the dispute is sufficiently clear to obviate the need for due diligence.
- iii) As currently drafted, the proposals do not reflect this balance - and seem to be inconsistent in any event.
- iv) For example, sections 1.1 d 4 and 1.1. d 5 of the commentary refer to an obligation to investigate portfolio differences and an obligation and specific structure to permit consultation to resolve apparent differences. However, if a party can merely accelerate to step 4 without any conditionality as to the circumstances in which the acceleration can take place such obligations are meaningless: a party could merely ignore them.
- v) Another example is provided within the general terms and conditions themselves. In the penultimate bullet point there is a condition relating to failure to perform. If a

party fails to perform the actions required in each step of the DR protocol by the prescribed times the other party can unilaterally decide to accelerate to the next step. This condition is irrelevant if any party can accelerate through all steps at its own discretion.

- vi) We would suggest that the right of acceleration is clarified so that it can be exercised under two circumstances:
 - (1) a party reasonably determines in good faith that an imminent default is about to occur in respect of its counterparty
 - (2) a party reasonably determines in good faith that the procedure set out in steps 1 – 3 is unnecessary since the trades under dispute are already clear

Response: TBD

- 2.8** The pre-defined timing structure of the protocol, though not mandated as can be extended and accelerated, will need to be reviewed in light of operational feasibility. As long as timings can be contracted where there is a need / desire, wide consultation will be required to determine realistic timings, to be tightened as the protocol is adopted across the market

Response: TBD

- 2.9** We currently adhere to an efficient dispute resolution time schedule with its counterparties. We recognize one of the goals of Phase 1 was for the dispute process to remain flexible; however, we recommend the time frame for Phase I be reduced as most informal disputes are resolved more quickly than the ISDA proposal proposes. As it stands, Phase 1 timing threatens to increase risk by creating a discrepancy between our current resolution time frames and the new market convention upon which a disputing counterparty may rely.

Response: TBD

- 2.10** The timing should be shortened to the maximum extent, keeping in mind that it needs to be practical. There is still the ability for both parties to mutually extend the timelines as appropriate. The ability of parties to unilaterally shorten the timing/move to the next step (and ultimately to Phase 2 DR process) as quickly as possible in the event that they feel a step is unnecessary/complete is an absolute requirement.

Response: TBD

- 2.11** As we reported during the drafting period, we believe that the timescales for the "standard" resolution are very tight; in a situation of severe market stress such as after the Lehman default (where a strong dispute resolution process is particularly needed), the protocol will not be achievable.

Response: TBD

- 2.12** Conceptually, it is good to be able to extend or accelerate a dispute resolution. However, the process of tracking which break is subject to the standard timetable, the accelerated or the extended timetable will be heavy to manage, especially in an environment of high volume of breaks. In a climate of high volatility / instability, the concept of "mutual consent" may cause serious stresses to the process.

Response: TBD

- 2.13** Timing regarding Step 1

- i) Step 1 as we understand it contemplates that the undisputed collateral amount would be moved on the day on which a collateral call is disputed ("T). Our experience is that a call would be disputed on the day that it is made, and that it is currently market practice to move the undisputed amount on the day after the margin call (which is consistent with the terms of most CSAs). Given that most of our CSAs provide for a 1pm Notification Time, and, in the case of a Return Amount, that the collateral to be

returned has often been rehypothecated, we see operational challenges with meeting such “same day” delivery timing.

Response: TBD

2.14 Timing regarding Step 2, 3, 4

- i) Without very significant (and costly) infrastructure changes, it is difficult to envision that we would be in a position to identify all “Transactions Under Investigation” across our portfolios by T+1, and to complete the consultation process by T+4. We would propose that Phase 1 be revised to allow for more time in each step (see, for example, the May 12 version of Phase 1). Over some reasonable period of time (taking into account regulatory considerations and preferred best practices), the timelines could be tightened. This would allow market participants some time to assess the impact internally (e.g. new processes / staffing / restructuring needs) of applying the DR Protocol, and to make the necessary infrastructure changes. We would expect that this approach would garner more support for the DR Protocol across the industry and more adoption. We will be providing some specific recommendations relating to timelines in response to the Feasibility Study that was issued to the industry on Friday

Response: TBD

2.15 Concept of Acceleration to Step 4 by Unilateral Action – It would be helpful to have more certainty /clarity regarding the test that must be met before a party may unilaterally declare that the DR Protocol is to be accelerated to Step 4 e.g. the meaning of “imminent credit danger”.

Response: TBD

2.16 We feel the standard default timing for the Steps in Phase 1 should be much shorter. We appreciate that there is a practical constraint on how fast these steps can occur in the ordinary course of business, imposed by the staffing levels that firms can economically devote to the functions to be performed, and the inherent communication delays involved in transferring data between organizations and facilitating conversations. However, we are concerned that in a true counterparty credit crisis situation, when ordinary course of business considerations may need to be overcome, it will be desirable to have much shorter timings. In such circumstances, it may be difficult to obtain the cooperation of the counterparty to tighten timeframes from those documented in the draft. By contrast, we believe it is more optimal for the standard default timings to be shorter, so that in a credit crisis situation there can be no argument over shortening them. In ordinary course of business situations, of course, we would expect the parties to permit extended timings for certain steps of the process, if the practical circumstances require it and risk considerations permit it.

Accordingly, we suggest the standard, default timing for the steps in Phase 1 (Steps 1 through 4a) to complete should be by the end of T+1 (as opposed to T+7). [See section [7.8](#) for a revised structure and proposed timeline for each step]

Response: TBD

3 Tolerance Levels

3.1 Different Thresholds for Illiquid trades and vanilla trades

- i) Illiquid and Structured trades may often be the underlying contributors for some collateral disputes and a threshold level needs to be set as a means to start investigations into issues. However we feel that for vanilla, less structured and more liquid trades a distinction needs to be made and for these deals the threshold needs to be a lot tighter than the ones suggested (\$20mm is too large, but we offer no suggestion for an alternative threshold) . Such thresholds, however, should take into account the running bps difference of trades.

- ii) Smaller yet significant differences on such trades can be an important contributor to collateral disputes, be a cause for internal concern and should not be ignored from investigation in this process.
- iii) In addition, many portfolios are subject to steps 1-3 as part of the 'business as usual' portfolio reconciliation work. Differences highlighted from this work should still be investigated and should not wait until a portfolio with one c/p comes into dispute. Potentially offsetting deals in different asset classes could hide a number of separate issues which could be investigated before a dispute becomes apparent. It is acknowledged that many firms may already be taking this proactive approach. Thus, we recommend all differences, including those that off-set need to be investigated, even when the sum of the differences totals less than the \$20mm dispute threshold.

Response: TBD

- 3.2** A tolerance level of 10 M does not appear appropriate. It would be better to define it according to the dispute amount.

Response: TBD

- 3.3** Page 5 (step 2 portfolio reconciliation) - More information would be helpful to explain how the amounts/methodology were derived to quantify the tolerance level for each product as a transaction under investigation.

Response: TBD

- 3.4** The trade tolerance level of 20MM per transaction (later in 2009 to be decreased to 10MM) is considered high. We would like to see dynamic tolerance levels tied to disputed amounts, portfolio size by counterparty, public debt ratings, etc. Although, it is noted that parties are not obligated to use established tolerance thresholds.

Response: TBD

- 3.5** We feel the dispute tolerance in Phase 1 is designed to capture those disputes which are significant from a dealer-to-dealer perspective. But, as an end user, we are sensitive to much smaller differences per trade. Therefore, we suggest Phase 1 incorporate either: 1) the opportunity for parties to permanently agree on a smaller Tolerance across all trades (note that these might ideally vary by agreement depending on the size of each counterparty in each case), or 2) have two separate tolerance levels, one appropriate for dealer-to-dealer trades, and one with a lower tolerance more appropriate for dealer-to-end user trades

Response: TBD

4 Unmatched Trades (Alleges)

- 4.1** The protocol should propose an ultimate dead line of resolution of unmatched trades

Response: TBD

- 4.2** To DR Protocol ends at step 3 on unmatched trades and states all trades < 5 days since trade date should be reconciled within 5 days of dispute. A) There is no mechanism in place for force engagement from step 3 of DR protocol B) Questionable how achievable the full reconciliation and incorporation of all trades in large portfolios is before specified deadline. Again, materiality on dispute level (value of alleged trade) and size or value of portfolio should be considered.

Response: TBD

- 4.3** Unmatched trades are not subject to any tolerance in the proposed process. In our view, materiality (and obviously age, possibly credit ratings) should be criteria that are factored in the dispute process. Considering a matching ratio of 98% on a given portfolio of 25,000 trades, 500 confirmations would have to be exchanged; this is impractical, especially as the exercise of exchanging confirmations would have to be repeated across portfolios. We would therefore recommend that the investigation of unmatched items be imposed to:

a- any unmatched of 90 days and longer (the 90 day period may be reduced over time as the industry's record on portfolio reconciliation improves); b- any unmatched trade where the pv is above the pv tolerance level already defined for pv differences; c- any unmatched item that hasn't yet been confirmed with the counterparty through the confirmation process.

Response: TBD

5 Step 4 - Mutual Informal Dispute Resolution

5.1 We will not promote the use of a temporary collateral adjustment considering that this method introduces only delays in the research of the resolution

Response: TBD

5.2 We will not use the resolution method which consists in not collateralizing some or all of the exposure (cf. 4a-4)

Response: TBD

5.3 Page 6 (step 4a-1 temporary collateral adjustment) - In the event of a bankruptcy it should be clarified whether the treatment of collateral posted under this method would be any different from collateral posted under the existing process.

Response: TBD

5.4 In the "Commentary" 4.1.b.3 – Preliminary Collateralization/Midpoint Collateral Amount: Using the midpoint collateral method incentivizes price manipulation by participating firms. The potential increases in the absence of common reference source pricing. There are also adverse consequences during times of market stress and pending counterparty insolvency.

party A	party b	mid point (x-y/2)
10	20	-5
10	100	45

Response: TBD

5.5 In the "Commentary" 5.1. – Summary of Step4a Methods:

4a-1 – Temporary Adjustment – Longevity of results and Disputes in Close Proximity to Default Events would be concerns

4a-2 – Common Reference Pricing – Limited application in exotic products

4a-3 – Mutually Agreed Exit – Not possible for asset managers

4a-4 – Other Resolution Methods – Is this intended as an out clause for practioners?

Response: TBD

5.6 In the "Commentary" 5.2.b.1 – Use of Common Reference Source Pricing – As mentioned, this makes sense for vanilla products but limited application for exotics. Seems to pave the way to CCPs. 5.2.b.4 – Raises an excellent point regarding the need to maintain/track multiple values per position:

"5.2.b.4. Firms will need to track multiple values per position (their own books and records value, plus potentially several prices provided by clearing houses). They will require logic to determine which source to use and computation to convert prices into MTM values"

Response: TBD

- 5.7** In the “Commentary” 5.3 – Longevity of Dispute Resolution Results – Could be problematic during period of stress or pending insolvency

Response: TBD

- 5.8** Pricing Disputes - With respect to the common reference prices in Method 4a-2 it would be more practical to mutually elect a pricing source for particular types of trades and apply this to all positions unless explicitly stated otherwise on the account rather than as a dispute resolution process. Additionally the mutually agreed exit of a position does not belong within proposals of dispute resolution as this can be achieved currently under the regular ISDA mechanisms.

Recommendation: election of pricing mechanisms for particular trade types.

Response: TBD

6 Implementation of Dispute Resolution

- 6.1** How about initially applying this new DR rule to transactions between OMG members only and testing the feasibility, adjusting the rule as necessary, and then applying that rule to a broader range of market participants?

- i) If it is to be a best practice rather than protocol, it would contradict the current provisions in the CSA and would be difficult for the participants to comply with.
- ii) Therefore, we think that either bilateral amendment of CSA or protocol is necessary to change the existing DR process

Response: TBD

- 6.2** Under no circumstances should this dispute resolution supercede counterparty rights in existing documentation or in the instance of a distressed counterparty, this protocol should not be intended to prohibit a move to legal action (ie move to liquidate if deemed necessary).

Response: TBD

- 6.3** We do not commit for a protocol signature before end of 2010 taking into account the workload of implementation of an adequate organisation. In counterpart, before this date, we are in favor of an informal experimentation of the protocol between FED 15 participants.

Response: TBD

- 6.4** Page 9 (implementation considerations) - We concur that a phased approach may be advantageous for the reasons provided in the commentary.

Response: TBD

- 6.5** Page 9 (implementation considerations) - The nature of market adoption of the DR Protocol will need to be clearly communicated and understood (ie, whether made available as an ISDA sponsored protocol during a defined adherence window, or a stand alone amendment for pairs of counterparties to bilaterally negotiate, or serve as an industry best practice document). This includes whether parties to existing CSA's would retain their current rights for dispute resolution.

Response: TBD

- 6.6** We think that it is unlikely that any party would sign up for a protocol for phase one without the inclusion of phase two. An effective dispute resolution process needs to be sufficiently certain to achieve a result. Such an objective will not be fulfilled if the process is merely left to consent.

If phase two cannot be agreed at this point then we would agree with the route suggested in section 7.2 b of the commentary, i.e. phase one is incorporated into paragraph 5 of the CSA but with the dealer poll retained until phase two is agreed.

We do not think that the solution of best practice guidelines would be effective. If the protocol is to fulfill its objective and result in an improved process then it needs to be incorporated into the CSA.

Response: TBD

- 6.7** Application of bilaterally negotiated valuation or calculation agent: Notwithstanding the recommendations from Phase II of the ISDA Disputes Protocol. It must be made clear that bilaterally negotiated terms referring to the obligations and rights of calculation and valuation agents within confirmations, Master Agreements and Credit Support Annexes / Security Documents are maintained and should not be replaced by any overarching agreed protocol.

Response: TBD

- 6.8** Legal Status of Protocol: The Phase I of the Dispute Resolution protocol should be implemented as a market best practice, reportable to supervisors.

Response: TBD

- 6.9** Questions on Implementation: The following presupposes the adoption of Phase 1 as a protocol.

- i) Can parties select a date of adherence? We would propose a specific addition of this if it was not already contemplated.
- ii) Is there an opportunity for an adhering party to opt out? We would prefer to maintain an ability to opt-out in the future without agreeing to this on a bilateral basis. This would most likely be utilized only if the Phase I procedures are not working as envisioned in future.
- iii) Can parties permanently agree on a smaller Tolerance and to agree to change this Tolerance level in the future? We would prefer some flexibility on this point.

Response: TBD

- 6.10** Phase 1 should be implemented as a Best Practices Statement (and not a hard-wired protocol or change to the CSA). It should be an explanation of the Best Practices relating to the parties consultation "with each other in an attempt to resolve the dispute" [see Para 5(3) of the NY Law CSA; Para 4(a)(3) of the English Law CSA] and should be expressed as a Best Practice for a particular size [e.g. 1000 trades] and complexity [e.g. less than 5% exotic or materially complex/structured] of portfolio and should include language that acknowledges that the timing and steps that are appropriate will vary from dispute to dispute and with the size and complexity of the portfolio [as well, perhaps, as the perceived credit condition/motives of the counterparty disputing the call].

Response: TBD

- 6.11** Initially, the protocol should be implemented as "best practice" code rather than a legally enforceable document. In effect, we believe that the process has to be tried out and should "bed down" before the next steps are envisaged.

Response: TBD

- 6.12** We would recommend that Phase 1 be introduced as a best practice document. Failing that, if an ISDA-sponsored protocol is adopted, then our preference is that it not have a defined adherence window.

Response: TBD

7 Dispute Resolution Structure and Points on Specific Steps

7.1 Mutual informal dispute resolution - use of common reference pricing - Step 4a-2: As part of the desk to desk conversation we feel that this should be one of the items for discussion and should be happening in Step 3 rather than step 4.

Response: TBD

7.2 On page 4 of the PowerPoint version Outline, under Step 3 'desk-to desk conversations to resolve valuations differences'; this should include the collateral desks of each counterparty

Response: TBD

7.3 On page 5 of the PowerPoint version Outline, under Step 2 point 3 "the list of transactions Under investigation must be identified by the end of T+1."; should add 'and mutually agreed between the two parties'

Response: TBD

7.4 On page 4 (timings) of the PowerPoint version Outline - Please clarify that these are business days

Response: TBD

7.5 On page 5 (step 1 preliminary collateralization) of the PowerPoint version Outline - The outline indicates that the undisputed collateral amount must be settled (current market practice). However the additional commentary document provides four potential methods that could be used to determine preliminary collateralization including no collateral moves, mid-point moves and full moves. The criteria to allow these further methods needs to be further clarified in the commentary.

Response: TBD

7.6 On page 5 (step 3 consultation) of the PowerPoint version Outline - Should also address disputes arising from legal agreement issues such as covered branches and covered products

Response: TBD

7.7 Terminology Contained in Step 2 - We propose to replace the term "valuation" with the term "mark-to-market." "Valuation" implies required disclosure of our sensitive information. Whereas, "mark-to-market" more accurately describes the necessary disclosure for portfolio reconciliation purposes. There should be nothing in Phase 1 which creates the expectation of disclosure of valuation methodology.

Response: TBD

7.8 We agree with all the processes involved in Steps 1 through 4a in the current proposal, but suggest the structure can be simplified.

- i) This is based on the observation that during the Consultation phase currently defined, it is natural that the discussion between the parties will be evolving towards the desired resolution method under 4a, or possibly the need to invoke Formal Dispute Resolution under 4b. It seems to us, therefore, to be artificial to split Step 3 and Step 4a, as they co-evolve in reality.
- ii) Accordingly, we suggest that Step 2 (Portfolio Reconciliation), Step 3 (Consultation), and Step 4a (Mutual Informal Dispute Resolution) should be collapsed into a single step, which we would propose to call "Step 2 Investigation and Consultation". For convenience, we have laid out how we would suggest the steps of Phase 1 be re-organized to give effect to this.

- iii) We believe this simplified structure would be easier to follow, implement and measure. By removing some of the breakpoints between steps, it also facilitates the tighter timeframes discussed above.
- iv) Proposal to Re-organize the DR Protocol Steps: [See section [2.16](#) for commentary on proposed timing reflected below]

Step 1: Preliminary Collateralization (No change)

[Starts on T and completes on T]

- Move collateral based on the Undisputed Collateral Amount Methodology
- Proceed to Step 2

Step 2: Investigation and Consultation

[Starts on T and completes on T+1 unless mutually extended]

- Exchange portfolio details and process the portfolio reconciliation
- Identify 'Transactions Under Investigation'
 - Trades with difference greater than the Tolerance level and all unmatched trades must be ring-fenced as Transactions Under Investigation
 - In addition, trades with difference less than the Tolerance level can be deemed Transactions Under Investigation by either party
- For Transactions Under Investigation with valuation differences
 - Both parties will have their internal trading desk or financial controllers confirm their marks
 - For any transactions internally re-affirmed above, desk-to-desk conversation between the counterparties will take place as needed to resolve valuation differences
- For Transactions Under Investigation that are unmatched trades
 - Both parties will collaborate to resolve any unmatched (alleged) trades; the alleging party must provide the confirmation and both trade references or the alleged common reference for centrally registered trades.
 - Recently executed trades yet to be confirmed are excluded from the requirement to resolve alleged trades during Step 2 for a period of 5 days after execution
- As a result of consultation, the parties may mutually elect one of the following methods to resolve:
 - 1 Temporary Collateral Adjustment
 - 2 Use of Common Reference Pricing
 - 3 Mutually Agreed Exit of Position
 - 4 Other Resolution Method
- Any trades not mutually resolved during Investigation and Consultation will be deemed 'Transactions Under Dispute Resolution' and proceed to Step 3

Step 3: Formal Dispute Resolution

- We will hold commentary for Step 3 which is being discussed as part of Phase 2 until the public commentary period for Phase 2 starts

Response: **TBD**

7.9 In the 'Commentary' 2.2 Discretion of Parties – This is an integral point which we would emphasize. 2.2.d is well stated:

“d. It is also the case that in a privately-negotiated market the parties are free to contract as they desire (not withstanding illegality) and to amend that contract as may be mutually agreed.”

Response: TBD

8 Metrics and Reporting

8.1 Phase I of the proposal puts a uniform structure and process for market participants to follow in an event of a dispute. A great amount of investment has been made in recent months across the industry in terms of building teams to cope with the increased demands required in the portfolio reconciliation space and developing internal escalation channels to address resulting issues. A useful ongoing statistic that could be submitted from firms responding to the dispute resolution proposal would be to see how many disputes they currently have that would move to Phase II or Steps 4b. This could be a useful figure to track over time if Phase I is adopted to see the impact Phase I has had on overall dispute figures and also the size of the issue that needs to be addressed for Phase II

Response: TBD

8.2 Page 8 (statistical reporting) - We would like to participate in determining these statistics as part of the implementation planning.

Response: TBD

8.3 Clarification of what is meant by the term "dispute" would add to the transparency of Phase 1. Furthermore, there should be exemption from reporting de minimus disputes. The current language contained in Phase 1 sets forth an exhaustive list of reporting breaks. Yet the excessive frequency of breaks resolved same day or of a de minimus amount may create burdensome reporting and may not be value-added from a regulatory perspective.

Response: TBD

8.4 Although the document is not specific about the reporting to the regulator, we understand that the industry is looking at implementing metrics. Firms are therefore likely to give specific attention to the items in excess of USD 10 mio; this means a risk that trade breaks below the tolerance level are given 2nd priority or worse, get overlooked. We have observed this pattern in the portfolio reconciliation space, where some firms are essentially driven by regulatory reporting considerations. In particular, risk mitigation will be poor in scenarios where: a- we have outstanding breaks close to, but below the USD 10 mio tolerance, or b- we have a single trade break close to, but below the USD 10 mio tolerance with a counterparty which hasn't got a strong credit rating

Response: TBD

8.5 Therefore, assuming that the industry is considering reporting breaks above the 10 mio tolerance level, the reporting should be complemented by a reporting showing the sum of pv breaks by counterparty (the cpy's name may not necessarily have to be disclosed), when the sum exceeds a given tolerance level. Counterparty credit rating could be factored in to differentiate tolerance levels.

Response: TBD

8.6 In the "Commentary" 6.1 – Statistical Reporting – Metrics should consider relative size of portfolios:

- i) 6.1.a.3 – Agreed. Also, we would suggest measuring the disputed amt relative to portfolio size. Disputed \$/Aggregate Notional Value of Portfolio.

“For each counterparty, the count per month of dispute events occurring and the percentage of margin calls disputed.”

Response: TBD

- ii) 6.1.a.4 – Good idea. Again, would encourage tracking count per month/# of trades in portfolio

“Count per month of Trades Under Investigation, Trades Under Dispute Resolution and Intractable Trades at any time during the month (include duplicates from overlapping disputes)”

Response: TBD

9 Operational Readiness

9.1 Portfolio Reconciliations

- i) With respect to portfolio reconciliation, are you defining a minimum set of fields that people must be able to provide on T to ensure that an efficient rec can be done? Will you commit people to providing these minimum fields?

(1) In our experience, trade data files sourced from dealer margin systems are not very rich nor that vendor rec processes support this as well as they could. We run our own in-house rec and receive custom files with a high level of detail from most major dealers. They've had to custom build these and it takes time... You might find that a t rec is pretty useless unless as part of the onboarding process you ensure that people can provide files quickly of high enough quality.

Response: TBD

- ii) Current reconciliations lack many fields to make complete and accurate identification for matching difficult. We support the ongoing work towards a consistent standard for submission and feel this is an important step in increasing match rates. Even with match rates in excess of 90% this can still lead to large number of breaks which need to be investigated. The additional fields which need to be submitted to reduce the 'noise' associated with such breaks should be accelerated.

(1) In addition to a consistent format of underlying trade data, trades should also show the last time inputs to a trade valuation such as curves, vols, spreads and skews were updated. By having this data available would give valuable information as to the potential cause of the dispute.

(2) A suggestion for discussion, although it is acknowledged it will not be a quick item to implement is for a central party to take a more proactive involvement in the managing of disputes and trade differences. For example unmatched trades should be resolved immediately and no later than T+2 as in the case of an exchange. Also with additional fields being provided by c/ps for reconciliation, this central party may be able to provide additional information as to the levels of similar trades across other matching relationships. It is not suggested that detailed information regarding the identity of other c/ps be provided but indications of where similar trades are being marked in other portfolios could be very valuable information that could potentially be shared. This could hopefully help reduce the current number of desk to desk conversations that need to take place

Response: TBD

- iii) Ability to perform portfolio reconciliations: Best practice should state that portfolios with greater than x trades in the portfolio should be performed on a shared reconciliation platform and updated on a regular basis to be determined

Response: TBD

9.2 Product specific Considerations

- i) Commodities Steering Committee: Firms indicated that because a) Commodity firms may not have the same IT budget that a number of the other firms have and b) there are generally not standard product codes for these transaction types, implementation of proposals may take time

Response: TBD

- ii) For FX trades, it is usually difficult to provide confirmations as evidence. In order to comply with the escalation requirements in Step 3 (Consultation), some firms may need a fundamental structural change to their internal collateral management procedure and therefore need to have further feasibility test.

Response: TBD

- 9.3** The protocol has a high reliance on Front Office staff. We tend to limit the involvement of front office staff where possible to maintain independence between back-office and front-office valuations

Response: TBD

- 9.4** In particular, we are concerned about the practical implications associated to volumes. In effect, considering the sub-set of FED16 counterparties, the number of trades that is above the tolerance level of USD 10 mio + a risk based deviation is in excess of 3,500 trades for the FED 16 group (as per Trioptima statistics). This means an average of approx 250 trades that each FED16 cpy needs to process through the various steps of the dispute resolution process. There will hardly be any room for prioritisation, as all disputes will have to be resolved within the short timescales set by the dispute resolution process

Response: TBD

- 9.5** We understand the purpose of the DR Protocol and agree that industry wide review and change is appropriate. However, we are not in a position to comply with Phase 1 as currently drafted at this time or in the near term. We do not currently have the necessary technical and human resources capability to perform portfolio reconciliations whenever required under the protocol or to appropriately investigate the results of such reconciliations.

- i) We understand the purpose of the DR Protocol and agree that industry wide review and change is appropriate. However, we are not in a position to comply with Phase 1 as currently drafted at this time or in the near term. We do not currently have the necessary technical and human resources capability to perform portfolio reconciliations whenever required under the protocol or to appropriately investigate the results of such reconciliations.

Response: TBD

10 Additional Points to Incorporate

- 10.1** The proposal doesn't seem to cope well with new trades which have big upfronts because (a) it envisages confirms are done within 5 days, not always true and (b) process basically excludes new trades, but these often do form a big part of a dispute, so it is a bad idea to exclude them.

Response: TBD

- 10.2** Scope of DR Protocol and Definitions: Will Japanese Law CSA be included in the scope of DR Protocol and Definitions? In other words, will they be worded in such a way as to replace Paragraph5 of Japanese Law CSA (1995 and 2008)?

Response: We haven't discussed this in depth yet, this will be added as an open point to address.

- 10.3** Treatment of transactions with parameter differences (See Question 1.4 above)

Response: TBD

10.4 What happens at the end of a 'longevity' period?

Response: TBD

10.5 Specific Points in the Document

- i) Page 10 – 2.3 – We should remove reference to credit stress events, also in the footnotes, as acceleration should not necessarily be dependent on pre-determined list of conditions

Response: TBD

- ii) Page 11 – 2.5 – View is that section should be removed. There should and re-thought through

- (1) Failure to perform can only be determined when the full period for each step has run through it's allotted time
- (2) The structure of the DR Protocol requires clear completion of each step, i.e. exchange of portfolios and performance of reconciliations. If a party fails to perform on these steps, then the remaining steps cannot be executed as structured.

Response: TBD

- iii) Page 11 – 2.6 – The following should be added: "It is anticipated that any regulated financial institution will (and should) be able to do so"

Response: TBD

- iv) Page 11 – 3.6 – For the avoidance of doubt, a party at any time may designate every-trade as a "Transaction Under Investigation", effectively setting the tolerance to zero

Response: TBD

- v) Page 11 – Footnote 5 – "It is recommended that recorded lines be used for this purpose in case of any controversy" should be removed

Response: TBD

- vi) Page 12 – 3.11 – "may be deemed" should be replaced with "will be". This refers to where dispute resolution processes have failed (in both phase I and Phase II). However, it must be made clear in the document, an "intractable dispute" should not necessarily result in no movement of collateral value under dispute. There should be reference to bilaterally negotiated terms. Valuation Agent terms should be applied.

Response: TBD

- vii) Page 13 – Step 3 – "Both parties will collaborate to resolve any unmatched (alleged) trades, the alleging party must provide the confirmation and both trade references or the alleged common reference for centrally registered trades" This assumes that an unmatched trade has been confirmed by the allege. This may not be the case, so it cannot be a required step.

Response: TBD

- viii) Page 14 – 4.3 – i) – "These 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" à Contradiction where must and necessary are stated, who determines necessary?

Response: TBD

- ix) Page 14 – 4.3 – iv) – Please review, this contradicts item 4.3 - i)

Response: TBD

10.6 Entry Criteria:

- i) We are concerned that not every case of a disputed margin call should warrant invocation of the Dispute Resolution Protocol - for example, in situations where the

size of the disputed amount is small in relation to the portfolio in question and there are no immediate credit concerns with respect to a counterparty (for example, a margin call of \$100mm where \$98mm is agreed and only \$2mm disputed, in connection with a portfolio of large size with a highly credit-worthy counterparty).

- ii) We note that when a disputed margin call occurs, as drafted, it is possible for the parties to agree not to invoke the Dispute Resolution Protocol; alternatively, of course either party may force it to occur. However, we believe it would be helpful to market participants and to external observers such as regulators if there were some guidance provided around when it may be appropriate for the parties not to invoke the process.
- iii) Accordingly, we suggest addition of language that (without constraining the abilities of the parties to agree not to enter the process, or the ability of either party to force it to take place) provides guidance on this issue and sets some broad entry criteria for the Dispute Resolution process.

Response: TBD

10.7 In the “Commentary” 8.2.c – Resolution of Margin Disputes versus Pre-Emptive Avoidance – Very good point and should be emphasized as adjacent priorities

“8.2.c. This can be achieved by several means:

1. Processing transactions via clearing house mechanisms, where eligible
2. Improving the trade confirmation process to detect and correct booking errors more rapidly
3. Increased use of electronic means to communicate between counterparties and thus reduce the scope
4. Agreement on the use of Common Reference Price Sources - see Section 5.2 for further discussion of this idea”

Response: TBD

10.8 In the “Commentary” 9.1.d – Disputes in Close Proximity to Default Events –

- i) 9.1.d. – The exposure created as a result of differences in Undisputed Amount makes Preliminary Collateralization extremely meaningful and potentially contentious. “9.1.d. However, it must be noted that the calling party will be exposed for the difference between their collateral call (or recall) and the Undisputed Amount for the duration of the DR process. This risk cannot be eliminated mechanically by the DR process.”

Response: TBD

- ii) 9.1.f – Interesting suggestion worthy of further industry consideration and discussion. Standardized language and protection would be great outcomes.

“9.1.f. The industry may also wish to consider whether an Escrow Rider to the DR Protocol might be adopted by parties (either universally or optionally*) which would provide for:

1. In the event that a collateral dispute is on-going and in the process of resolution through the DR Protocol, then if not resolved by the [XX]th day then each party shall settle to an agreed escrow agent the additional delivery or return of collateral being claimed by the other party (if any), to be held by the escrow agent until the dispute is resolved, at which point it would be released to the party that prevails in the DR Process.
2. * In which case the Escrow Rider would apply only as between parties each of which had adopted it”

Response: TBD

10.9 Settlement – Different counterparties reflect novated trades on settlement or trade date. Given the volume of novations in the market this leads to material discrepancies in the exposures that counterparties reflect and hence as a fund you are exposed to having to

fund or dispute the margin call due to a lack of market standards. For some counterparties these novations are material to the overall account and hence will lead to inflated numbers if the proposed “Statistical reporting” approach is implemented

Recommendation: guidance be provided on when novated transactions fall into the portfolio for collateral valuation

Response: TBD

- 10.10** Perhaps consider dispute wording, which allows the parties to choose a third party/third parties to conduct the valuation if there is no resolution

Response: TBD

11 Q & A

- 11.1** Can you please explain how you anticipate this being integrated into the market. I would guess you will issue a protocol and ask people to adhere which will cover all trades between any parties signed up? How would you carve trades out?

Response: This point is still under discussion, see topic 3 (Implementation of Dispute Resolution) for the various views.

- 11.2** Resolution methods: is the idea that parties contract to the methods (and sources / fallbacks) in advance?

Response: This point is still under discussion, see topic 3 (Implementation of Dispute Resolution) for the various views.

- 11.3** Preliminary Collateralization: What is the preferred method for Preliminary Collateralization? Should collateral be moved based on Undisputed Collateral Amount Methodology? Or should it be moved base on Midpoint Collateral Amount Methodology?

Response: For this step, the Undisputed Collateral Amount methodology should be used. However, if parties mutually decide to use the midpoint they are able to do so.

- 11.4** Treatment of transactions with parameter differences: Commentary says that unmatched trades need to be reconciled during Step 2, and they are to be excluded from Transactions Under Dispute Resolution. How should transactions with parameter differences be treated in Steps 2 and 3? Should they be settled in Step 2, or can they be subjected to Step 3 process? Also, are there any tolerance thresholds for parameter differences, like those for value differences?

Response: Thanks for pointing this out, we did not explicitly include parameter differences but resolution and investigation of this should likely be similar to unmatched trades because essentially there must be 1 party who is right and trades should be amended as such. However, since parameter differences do not necessarily impact collateral, I think we should consider whether timeframes are legislated or if this is in scope for Dispute res at all. I will add this as an open point to be answered.

Q2: Some parameter differences could lead to value differences, and thus it would be desirable to explicitly define procedures for the treatment of transactions with parameter differences and those with parameter and value differences. As you suggest, parameter differences should be settled in Step 2 (Portfolio Reconciliation) just like unmatched transactions. If values differences still remain even after parameter differences are settled, then they should be subject to Step 3 (Consultation).

Response: To clarify, parameter differences would be identified in Step 2 (via the portfolio reconciliation), but investigated and fixed in Step 3 (via consultation which includes both internal and external conversations as needed). Thanks for the comments on parameter differences, we will add this as a point to address from the comment period.

- 11.5** Longevity of the results from the DR process: Commentary says that the results from the DR process must have a finite longevity. Does it mean that at the end of the pre-determined period, the following collateral needs to be returned to the Obligor?
- Collateral that was moved for Temporary Collateral Adjustment
 - Collateral that was moved on the basis of Common Reference Pricing

Response: Longevity of the results from the DR process The longevity of the results applies to how long the results may be used for collateral purposes. At the end of the longevity, if there is still a dispute, parties essentially need to undergo the process again.

Q2: I apologize for lack of understanding on my part, but I am afraid I am a little bit confused about the intent, or purpose of "longevity". The term "results" seems to imply that the dispute is settled and agreement is reached in some way or other in Step 4a (Mutual Informal Dispute Resolution). May I understand that the results in Step 4a are to be attained even if a dispute itself still remains at the outset of the "longevity" period? Or, is the longevity pre-determined because one party or other may change its mind after the dispute is resolved in Step 4a?

Response: One of the challenges/issues with the current dealer poll process in the CSA is that there is no concept of longevity once a result is obtained from dealer poll. Therefore, essentially the dealer poll result (value of the trade) can only be used for 1 day and the process must start over again. The effort required in order to get the result is usually not insignificant. Therefore the proposal in Phase 1 is that there be informal dispute resolution methods (step 4a) considered prior to a formal dispute resolution method (e.g. dealer poll or other method involving a 3rd party). Instead of redoing the process every day, if a result is obtained from step 4a, the proposal is to allow that result to be valid for more than a day. The result in this instance is whatever was agreed for collateral purposes via a method in step 4a.

11.6 Questions on Step 2: Portfolio Reconciliation

- Will "\$20mm per trade" be measured by difference of exposure or notional amount?
- Is there any explanation to why Tolerance is \$20mm?
- Can parties bilaterally agree to raise or lower the Tolerance?

Response: The Tolerance is measured by difference in exposure. The Tolerance has now dropped to greater than \$10mm plus a risk based deviation per product. Please see the Appendix of the March Update letter which provides a detailed explanation on how this is calculated and why. Both parties have the right to unilaterally decide to include any trade below the Tolerance.

11.7 When parties move to Step 4a-1 (Informal Dispute resolution Method - Temporary Collateral Adjustment) after T+5, as of which valuation date should the parties calculate the amount of adjusted collateral?

Response: TBD

11.8 Would ISDA please confirm that the following are not affected or amended by the DR Protocol:

- 1) Paragraph 4 Dispute Resolution in the 1995 ISDA Credit Support Annex (Transfer - English Law) and the parties' agreed Resolution Time in Paragraph 11(c)(i); and
- 2) Paragraph 5 Dispute Resolution in the 1994 ISDA Credit Support Annex (Security Interest - New York Law) and the parties' agreed Resolution Time in Paragraph 13(f)(i)

Response: This point is still under discussion, see topic 3 (Implementation of Dispute Resolution) for the various views. Depending on the outcome and decision on how this will be implemented, the above may be affected/amended.

11.9 Page 4 Step 2 refers to "Tolerance" currently agreed at \$20mm – can you please confirm where this amount is published and when /where the reduction in tolerance amount to \$10mm will be published

Response: Please see the Appendix of the March Update letter which provides a detailed explanation on how this is calculated

11.10 Under Method 4a-2 - Common Reference Pricing, if a party's valuation is found to be off-market after obtaining dealer quotes, going forward should that party amend their valuation methodology for the disputed trade?

Response: TBD

11.11 The protocol lists a "split the difference", where the collateral calculation is modified by both parties, as a possible resolution method. We would like to clarify that this method means that the pvs of the disputed deals are modified for the purpose of the margin calculation (rather than the split the difference applied to the margin call amount itself).

	Before resolution		Dispute resolution			
	party A	party B	split the diff. on disputed pv		split the diff on margin call	
	party A	party B	party A	party B	party A	party B
pv deals agreed	100	100	100	100	100	100
pv disputed deal	40	20	30	30	40	20
collateral position	120	120	120	120	120	120
threshold	15	15	15	15	15	15
call	5	0	0	0	5	0
outcome of the call	dispute of 5		no margin exchanged		split, ie 2.5	

Response: If you are referring to the "split the difference" as mentioned in the Outline within Section 5 below, then you are correct, the difference that would be split is the pv difference on the disputed deal.

"5.1.vi) 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."

12 Commentary Contributors

12.1 The comments above have been provided by the following firms but have been kept anonymous

Bank of America Securities
Barclays Capital
Barclays Global Investors
BNP Paribas
BP Oil International Limited
Brevan Howard Asset Management LLP
Citi
CQS
Goldman Sachs
GSAM
HSBC
Mitsubishi UFJ Securities
National Australia Bank
Purrington Moody Weil LLP
Soc Gen
TD Securities
The Norinchukin Bank
UBS
Unattributed Buy-Side Firm

13 Document A. Fed March Update Letter - Portfolio Reconciliation Tolerance

March 31, 2009

Mr Theo Lubke
OTC Derivatives Supervisors Group
Federal Reserve Bank of New York
33 Liberty Street, 10F
New York, NY 10045

Dear Theo Lubke,

In our 2008 industry letters (October 31 and December 31) the Major Dealers set out a comprehensive set of commitments to reform market practice in the collateral management space. The essence of those commitments was:

- a) To rapidly put in place robust **Portfolio Reconciliation** practice to detect significant trade population and valuation differences that could give rise to disputed collateral calls;
- b) To follow that up with a new **Dispute Resolution** process for the industry; and
- c) To set out a **Roadmap for Collateral Management** that will guide the evolution of this segment of the market over the coming years.

In late April we will update you with progress on Dispute Resolution, and in late May will do likewise with regard to the Roadmap. In this update letter we would like to focus on latest developments with respect to Portfolio Reconciliation.

In December, we undertook to revert to you by March 31 with proposals to develop a risk-based tolerance to replace the fixed \$20mm level that is currently being used for reporting value differences from the collateralized portfolio reconciliation process. As you are aware, this tolerance is used in the statistical reporting of portfolio reconciliation differences that the industry provides to regulators on a monthly basis. It is also proposed that this tolerance will play an important role in the new Dispute Resolution process which is currently under development. A more sophisticated approach to this tolerance is desirable because (for instance) a \$20mm mark-to-market difference in the context of a \$100mm notional derivative is clearly of much greater risk significance than the same size difference in context of a \$1bb notional derivative. In addition to size of transaction, tenor is also an important factor in benchmarking the risk presented by a difference of any given size.

The Major Dealers have jointly agreed to adopt a risk-based methodology which combines a reduced dollar threshold (proposed to be \$10mm per trade) plus an additional deviation threshold which ensures that the differences reported are in fact material in context. The deviation methodology uses a product-specific approach to filter out trades with large notional amounts and/or long tenors where a \$10mm reporting threshold would not be material in relation to the trade. The details of the deviation threshold versus product matrix are included in the Appendix as a Technical Note.

The level and methodology for reporting material valuation differences has been agreed by all the Major Dealers and was determined as a practical balance between a manageable number of examples and the desire to reduce the size of difference captured by the process. The Major Dealers will continue to review the thresholds used in reporting, at least annually, with an eye to continuing to tighten the definition over time.

The new reporting thresholds will be implemented by the end of May, so in practice the first reporting period to regulators using the revised criteria would be June 1 to June 30; as usual, the report for this period will be received by supervisors in mid-July.

In the meantime, we would be very happy to respond to any questions you may have, and in due course we will update you on other Collateral Committee activities around the Collateral Management Roadmap and the new proposal for Dispute Resolution that the industry has been working on. We will also continue to keep your staff updated with progress on other future deliverables.

Yours sincerely,

Julian Day
Head of Trading Infrastructure
International Swaps and Derivatives Association, Inc. (ISDA)

Michael Clarke
Managing Director, UBS AG
ISDA Collateral Committee Co-Chair

Shaun Sheppard
Executive Director, Goldman Sachs
ISDA Collateral Committee Co-Chair

The contents of this letter have been approved by, and are sent on behalf of, the Major Dealer members of the ISDA Collateral Committee;

<i>Bank of America, N.A.</i>	<i>HSBC Group</i>
<i>Barclays Capital</i>	<i>JP Morgan Chase</i>
<i>BNP Paribas</i>	<i>Merrill Lynch</i>
<i>Citigroup</i>	<i>Morgan Stanley</i>
<i>Credit Suisse</i>	<i>The Royal Bank of Scotland Group</i>
<i>Deutsche Bank AG</i>	<i>Société Générale</i>
<i>Dresdner Kleinwort</i>	<i>UBS AG</i>
<i>Goldman, Sachs & Co.</i>	<i>Wachovia Bank N.A</i>

Appendix 1. Technical Note

The proposal that the Major Dealers have jointly agreed to adopt is a risk-based methodology which combines a reduced dollar threshold (proposed to be \$10mm per trade) plus an additional deviation threshold which ensures that the Valuation difference reported is in fact material in the context of a particular trade.

The Product Matrix is depicted in Figure 1. The matrix lists the threshold for each product type in terms of basispoints for Credit and Interest Rate trades, and percentage of notional for Energy, Commodity, FX, Equity, and Cross Currency trades. Determining the basis point differential which takes into account notional size and tenor of the trade was shown as the relevant criteria for Credit and Interest Rate products. However, analysis of MTM differences on other OTC classes showed a minimal impact from trade tenor, and therefore a simplified calculation based on percentage of notional has been adopted. Formulae and worked examples are below in Appendices 2, 3 and 4.

Basispoint differential is calculated by taking the absolute MTM difference between the 2 trades and dividing by the Notional times the number of remaining years in the contract. To convert to basis points, the result is multiplied by 10,000 (i.e. 1 basis point equals 0.0001)

Formula = [Absolute (MTM Party A + MTM Party B)] / (NOTIONAL * YEARS) * 10,000
See Appendix 2 for further details

Percentage notional is calculated by taking the absolute MTM difference between the 2 trades and dividing by the Notional. To convert to a percentage, the result is multiplied by 100

Formula = [Absolute (MTM Party A + MTM Party B)] / NOTIONAL * 100
See Appendix 2 for further details

Figure 1. Product Matrix

Asset Class	Sub Category	Threshold	Type
Credit		45	Basispoints
	Index	40	Basispoints
	Single Name	60	Basispoints
	Tranche	100	Basispoints
Interest Rate		20	Basispoints
	Option	35	Basispoints
	non Option	15	Basispoints
Energy/Commodity		20	% of Notional
FX		3	% of Notional
	Option	10	% of Notional
	non Option	2	% of Notional
Equity		25	% of Notional
CrossCurrency		10	% of Notional

Appendix 2. Formula for Calculating Valuation Differences

FORMULA

MTM A = MTM from Cpty A

MTM B = MTM from Cpty B

Notional = Notional of the trade

Years = Remaining years of the contract

	MTM	Notional	Years
Cpty A	MTM A		
		Notional	Years
Cpty B	MTM B		

Formula - Basis Point Relative MTM Threshold

$$\text{MTM Diff} = \text{abs} (\text{MTM B} + \text{MTM A})$$

$$\text{Basis Points} = \frac{\text{MTM Diff}}{\text{Notional} * \text{Years}} * 10000$$

	MTM	Notional
Cpty A	MTM A	
		Notional
Cpty B	MTM B	

Formula - Percentage of Notional Relative MTM Threshold

$$\text{MTM Diff} = \text{abs} (\text{MTM B} + \text{MTM A})$$

$$\text{Pct of Notional} = \frac{\text{MTM Diff}}{\text{Notional}} * 100$$

Appendix 3. Credit Index trade Examples – Basispoint Deviation Threshold

Credit Index Trades

Example: Credit Index Trades with near-term maturity date vs. long term maturity date.

For Credit Index Trades, an absolute MTM difference threshold of 10 million plus a relative threshold of 40 basis points is used

A basis point is 1/100 of a % per annum. Interest rate differentials and credit spread differentials are often expressed in basis points.

Non discounted basis point values are used in the valuation difference calculations

Key

Falls below threshold (Not Valuation Difference)

Falls above threshold (Is a Valuation Difference)

A) NEAR-TERM MATURITY DATE

MTM	Notional	Years	Calculations	Results	
Cpty A (40,000,000)	100,000,000	3	MTM Diff = abs (35,000,000 + (40,000,000)) =	5,000,000	----> Is below absolute 10 million threshold.
Cpty B 35,000,000			Basis Points = $\frac{5,000,000}{100,000,000} * 3$	166.7	----> Is above relative (40) threshold.

Not counted as supervisory Valuation Difference

B) NEAR-TERM MATURITY DATE - With Larger MTM Difference than Example A)

MTM	Notional	Years	Calculations	Results	
Cpty A (40,000,000)	100,000,000	3	MTM Diff = abs (25,000,000 + (40,000,000)) =	15,000,000	----> Is above absolute 10 million threshold.
Cpty B 25,000,000			Basis Points = $\frac{15,000,000}{100,000,000} * 3$	500.0	----> Is above relative (40 bp) threshold.

Counted as supervisory Valuation Difference

C) LONG-TERM MATURITY DATE - With longer Tenor than Example B)

MTM	Notional	Years	Calculations	Results	
Cpty A (40,000,000)	100,000,000	40	MTM Diff = abs (25,000,000 + (40,000,000)) =	15,000,000	----> Is above absolute 10 million threshold.
Cpty B 25,000,000			Basis Points = $\frac{15,000,000}{100,000,000} * \#$	37.5	----> Is below relative (40 bp) threshold.

Not counted as supervisory Valuation Difference

Appendix 4. FX Option Trade Examples – Percentage of Notional Deviation Threshold

FX Option Trades

Example: FX Option Trades with small notional vs. large notional

For FX Option Trades, an absolute MTM difference threshold of 10 million plus a relative threshold of 10 pct of Notional is used

A) SMALL NOTIONAL TRADE

	MTM	Notional	Calculations	Results	
Cpty A	(50,000,000)	50,000,000	$18,000,000 + (50,000,000) =$	32,000,000	----> Is above absolute 10 million threshold.
Cpty B	18,000,000		$\frac{32,000,000}{50,000,000} * 100 =$	64.0%	----> Is above relative (10%) threshold

Counted as supervisory Valuation Difference

B) LARGE NOTIONAL TRADE

	MTM	Notional	Calculations	Results	
Cpty A	(50,000,000)	500,000,000	$18,000,000 + (50,000,000) =$	32,000,000	----> Is above absolute 10 million threshold.
Cpty B	18,000,000		$\frac{32,000,000}{500,000,000} * 100 =$	6.4%	----> Is below relative (10%) threshold

Not counted as supervisory Valuation Difference