



Going Forward : A Strategic Plan

Introduction

In its annual Benchmarking Survey 2003, ISDA reported research from the Bank for International Settlements entitled 'OTC Derivatives Market Activity in the Second Half of 2002' showing that notional amounts outstanding in swaps and other privately-negotiated OTC derivatives now stood at \$142 trillion, an 11% increase from six months before.

Such growth is continuing evidence that OTC derivatives have established themselves as a widely recognised tool for financial and risk management in the international marketplace and there is every indication that this trend will continue. The rapid rate of growth has, however, raised concerns about developing capability to process and settle the growing volume of trades. This is challenging the ability of market participants and service providers to introduce automated technologies as a solution. The US Federal Reserve Chairman, Alan Greenspan, drew attention to the importance of this development:

« .. the way that OTC derivatives are traded and settled clearly could be significantly improved. Despite, or perhaps because of, the rapid pace of product development, the derivatives industry still executes trades predominantly by telephone and confirms them by fax. Systems for the electronic execution and confirmation of trades require a degree of standardization and a large measure of cooperation that are not required for developing new instruments. Still, the derivatives industry has a long history of cooperating to standardize documentation, and it is disappointing that so little progress has been made in adopting efficient and reliable means of executing and confirming trades. » (Global finance : is it slowing? March 7, 2003)

The ISDA Benchmarking Surveys since 2000 have reported year-on-year improvement in developing automated solutions and demonstrated investment by member firms in technological systems to process the increasing volume of trades. The ISDA Operations Committee, which sponsors the Survey, appreciates these challenges and, over the past two years, has been actively building co-operation among its members to reach consensus on standardisation across a broad range of operational issues, which underpin the ability of the marketplace to implement automated solutions. Two industry Summits in 2002 and 2003 have led to a broad range of initiatives through which members have worked to further standardisation in the market and develop best practices for operational processing.

The ISDA Operations Committee considers that members may accelerate the pace of change through commitment to a vision for the industry over a 3-year Plan. A Strategy Group of the Operations Committee, comprising Operational heads from member banks, has worked to develop a vision for standards in operational processing by 2006. The intention is to facilitate a common direction, a conformed approach, and to provide a clear framework for commercial service providers in respect of the standards and expectations which the major participants are working to implement.

Strategy

The professional marketplace should work together to develop a unified strategy, standards and best practices to benefit the industry as a whole.

The catalyst for efficient and volume-insensitive operational processing is automated data transfer, both internally within firms and externally in the marketplace. The advent of electronic messaging for OTC derivatives has provided a platform for participants to harness these benefits. The clear market standard being widely adopted is Financial products Markup Language (FpML). Member firms will support continued development of FpML and use of this electronic message as a standard within the industry.

To support increasing volumes, the market needs to move towards an exception processing environment. This will entail development of electronic systems to match and reconcile data between market participants. These systems should support FpML as the industry standard platform for communication. By offering cost effective, accurate and inclusive methods to electronically generate, dispatch and match confirmations, reconcile settlement cashflows and traded portfolios for OTC derivative trades, the market will move towards the operational processing model set out in the vision below.

Automation is seen as a main strategic driver in the marketplace over the next 3 years. All participants and commercial service providers should position themselves for demand to send and receive messages in FpML format across a range of operations processes. Overall, the major dealers within the industry should adopt an approach which is consistent, minimises barriers to entry and encourages market growth.

Objectives

This Strategic Plan identifies a «best in class» approach within the industry, appreciating that not all member firms will have the technology investment or capability to achieve the vision by 2006. However, a firm strategic direction for the marketplace driven by the major participants may assist other participants, end-users and service providers to position themselves with some measure of certainty for future investment.

Where elements of the vision are already in place goals can be achieved more quickly, whereas other aspects will require additional time to design and implement. A tiered approach which targets timelines around product objectives is suggested at Appendix I. These timelines will need to be refined to reflect the wider priorities of the industry as a whole and a consultation phase following publication of this Strategic Plan will seek to establish an Implementation Plan which is representative of views and requirements across a broad range of market users.

Implementation should be viewed as a 3-year plan through which the market can focus on the development of technology and drive for standardisation needed to support this Strategic Plan. Recognising that this will be an evolutionary process, guidance on best practice and recommendations on converging market practice are suggested in Appendix II.

Members of the ISDA Operations Committee set out in Appendix III sponsor this Strategic Plan as an operational blueprint for evolution of the OTC derivatives industry to the benefit of all market participants. The Operations Committee would like to encourage wide participation from the marketplace during the forthcoming implementation phase which will look to define and shape an inclusive and flexible model for OTC automation in the future.

Vision

By 2006, the professional marketplace should aim to achieve substantial automation in the processing of trades. By this means, the market will move to reduce operational risk through developing capability for straight through processing, bi-lateral settlement reconciliation and portfolio matching within agreed upon timeframes.

○ **Confirmations**

The market should work together to substantially reduce risks from economic discrepancies and misunderstandings by developing systems which enable timely confirmation of trades.

Regardless of the method, the strategic vision for vanilla OTC derivatives is to electronically match and electronically affirm (legally execute) all inter-dealer transactions as soon as possible on or after Trade Date with certain reasonable exceptions for time zones.

In the wider market, practice around confirmation and execution should support a significant reduction in the interval between deals being traded and agreed by both parties:

- verification of principal economic trade details (“Trade Verification”) by T+0 for all trades
- dispatch of a Confirmation by one or both counterparties (in accordance with market practice) containing full trade terms (“Trade Confirmation”)
 - for vanilla automated OTC products on T+1
 - for complex manual transactions as soon as practicable following Trade Date and no later than T+5
- checking and resolution of queries in respect of any Trade Confirmation and agreement between both parties (whether evidenced by signature, by matching, by affirmation or automatching through a vendor service) of the full terms of the transaction (“Legal Execution”)
 - for vanilla automated OTC products by T+5
 - for complex manual transactions as soon as possible following receipt and no later than T+10

The unique nature of the OTC market in tailoring deals to customer requirements means that a proportion of confirmations will undergo legal drafting and review. Firms will need to make risk-based choices between adhering to target timeframes and the need in certain cases to take additional time for confirmation negotiation or to obtain enhanced credit.

Business events in the life-cycle of a trade (for example amendments, novations, cancellations, option exercises, corporate actions) should reflect similar standards to Trade Confirmation and Legal Execution. Business events should be included within the functionality of systems developed to confirm and match deals.

○ **Settlement Efficiency & Cashflow Matching**

Where possible counterparties should seek to reduce settlement effort through the following techniques :

- netting of cashflows between any two counterparties across OTC derivative transactions for a particular settlement date
- novation of transactions to a high quality clearer who can act as central counterparty to the trade
- active management of the historical trade portfolio, for example through swap tear-up arrangements.

Market participants should support development of solutions to reconcile current and future cashflows over the broad spectrum of their OTC portfolios. Upcoming cashflows for any Settlement (Payment) Date should be matched and netted between the two contracting counterparties within any product class (for example, interest rate or credit or equity derivatives):

- parties submit schedule of upcoming payments by S-10
- resolve any discrepancies and agree match by S-5
- agree net cashflow by S-2

○ **Cross-Product Netting**

The end-state architecture should enable systems which can undertake cross-product matching and netting of cashflows across all OTC transactions for any given Settlement Date. This applies in the case of any two legal entities and does not extend to inter-group arrangements. This aspirational objective could be achieved through provision of a clearing - type service provided to the marketplace.

○ **Portfolio Reconciliation**

The market should move to enable reconciliation of daily trading and legacy portfolios for purposes of reconciling trade booking and total population. Potentially this can be achieved through development of an electronic environment that facilitates Settlement and Portfolio reconciliation with associated bilateral netting of agreed cashflows.

Target Timelines

Key elements in achieving the vision of efficient operational support, volume insensitivity and control of risk will be the dialogue and commitment between market participants, and discussions with service providers based on requirements for electronic data transfer. It will require time to develop and implement technological solutions and a bifurcated approach is recommended based on products for which elements of commercial services are now available and those for which services need to be developed.

The outline timelines to implement the objectives of the Strategic Plan are:

Product	Process	Timeline
Interest Rate Derivatives Credit Derivatives	Trade Verification Trade Confirmation Legal Execution	December 2004
Equity Derivatives FX Derivatives Commodity Derivatives	Trade Verification Trade Confirmation Legal Execution	June 2005
All OTC product classes	Cashflow Matching	December 2005
All OTC product classes	Cross-Product Netting Portfolio Reconciliation	December 2006

Best Practice

The market will need to work together closely in the drive for continuing standardisation of operations processes. It is agreement by the market on consistency and approach that underpins the ability of technology to provide solutions. To assist participants in moving towards the strategic goals and vision set out in this document, the recommendations below are set out as guidance on interim standards:

Trade Confirmation

Trade Confirmation of vanilla OTC derivative transactions should be accomplished within 24 hours of Trade Date wherever possible. Outgoing confirmations should be generated and delivered to counterparts by T+1 local Business Days for vanilla transactions that can be automated internally or for which a commercially available trade affirmation or automatching service is available.

For all other transactions, the Trade Confirmation should be despatched as soon as practicable after Trade Date, with a benchmark of T+5 being exceeded only in exceptional circumstances (for example, complex transactions where specialist legal drafting is required).

Legal Execution

It is the responsibility of the receiving counterparty to check all incoming confirmations and notify counterparts of discrepancies within 2 local Business Days of receipt.

Queries relating to trade economics should be resolved no later than 3 Local Business Days following notification, and any amended Trade Confirmation despatched to the counterparty within 24 hours of resolution.

Overall, the process should support full Legal Execution of a deal (by signing a Trade Confirmation, by matching, by affirmation or automatching through a market service) within 7 local Business Days of Trade Date.

Trade Verification

Trade Verification by telephone may be employed in the event that a confirmation is not received from a counterpart (in written or electronic form) within T + 2 local Business Days. It is noted however that market practice for some products in the OTC derivatives industry has already developed to telephone confirm trades within a shorter timeframe.

Any dealer that transmits a confirmation within 24 hours should not be subject to accommodate a verbal confirmation. Clearly in markets where two-way confirmation is not the norm or where counterparts have agreed not to draft a confirm the non-confirm generation party must respond to a request for Trade Verification on T+2.

When written or electronic confirmations cannot be generated by a dealer within the above timeframe, or that dealer does not respond to a Trade Confirmation received, it is the responsibility of that dealer to appropriately staff and respond to a request from the other party for Trade Verification.

A standardised spreadsheet may be used in place of telephone confirming trades as a means of confirming the basic economic terms for a series of trades. Participants should exchange spreadsheets in FpML or other mutually acceptable format and provide capability – either internally or externally through service providers - to auto-reconcile key economic data to their own systems.

Broker Confirmations

The timely checking and reconciliation of broker confirmations is an essential control that should be adopted by all market participants. Brokers should be held to the standard of delivering their confirmations on Trade Date. Discrepancies should be resolved as soon as possible, and by no later than 24 hours following receipt.

Broker confirmations should be delivered to dealers in the standard FpML format.

Term Sheets for Complex and Bespoke OTC Trades

It is recognised that trades that are exotic in nature will require additional time to generate a Trade Confirmation. For these types of trade, an interim term sheet identifying principal economic data and principal terms should be delivered to the counterpart by T + 1 Local Business Days.

Cashflow Matching

In order to reduce the volume of settlement issues, cash flows should be matched by market participants in advance of settlement. As far as possible this matching should be achieved by electronic means (for example, exchange of spreadsheets or by using a central matching service provided by a vendor).

- Upcoming cashflows for periodic payments (for example, regular premium payments, fixed or floating legs etc.) should be
 - submitted by S-30 for all interbank participants;
 - payment discrepancies and queries resolved by S-5
 - net cash flows agreed by S-2
- Non-periodic payments (for example, settlement of upfront fees, upfront premium payments, unwind fees etc) would not be subject to cashflow matching for timing reasons.

Product netting should be utilised wherever possible within product classes.

Firms should look to develop systems which enable cross-product matching and netting of cashflows across all OTC transactions for any given settlement date. This applies in the case of any two legal entities and does not extend to inter-group arrangements.

Integrity of Data Records

Errors in settlement instructions continue to be a cause of cash fails in the market – firms must be responsible for communicating any changes in SSIs in a prompt and accurate manner as well as responding to any changes they receive

Another major cause of settlement fails is incomplete counterparty data relating to legal entity or booking location. Particular care should be taken at the Trade Verification and Cashflow Matching stages to ensure these details are correct.

Resolution of Settlement Discrepancies

Where issues do occur on settlement despite the matching process firms have an obligation to deal with these issues in a prompt and efficient manner. Firms should notify counterparties of any issues by S+2 at the latest and should expect a response by S+5. Where errors result in an interest claim the timings for submitting and dealing with the claim should be in accordance with market guidelines.

Reducing Ongoing Portfolio Maintenance Costs

In order to reduce the ongoing cost of maintaining Swap portfolios dealers are encouraged co-operate with counterparties wishing to either novate transactions to a high quality central counterparty or conduct an economically neutral tear up process.

ISDA Operations Committee

The members of the ISDA Operations Committee listed below sponsor this Strategic Plan as an operational blueprint for evolution of the OTC derivatives industry to the benefit of all market participants:

ABN Amro
Bank of America
BNP Paribas
Barclays Capital
Credit Suisse First Boston International
Deutsche Bank
Goldman Sachs
Greenwich Capital
JP Morgan Chase
Merrill Lynch
Mizuho Capital Markets
Royal Bank of Scotland
Societe Generale
Morgan Stanley
UBS