ISDA
Collateral Committee

Feasibility Study Implementation Plan: Extending Collateralized Portfolio Reconciliations

April 12, 2010

ISDA®
International Swaps and Derivatives Association, Inc.

TABLE OF CONTENTS

© 2010 International Swaps and Derivatives Association, Inc

1 Terms of Reference

1.1 Introduction and Background

This Implementation Plan takes it terms of reference from the Feasibility Study entitled "Extending Collateralised Portfolio Reconciliations" dated 18 December 2009 and published by ISDA ("Feasibility Study").

The Feasibility Study and this Implementation Plan respond to recommendations published in August 2008 by the Counterparty Risk Management Group III ("CRMPGIII") in a paper on risk management in the financial markets Containing Systemic Risk : The Road to Reform[1]. This included a recommendation V-10 that addresses the need for transaction portfolio integrity between any pair of counterparties, which stated: "The Policy Group further recommends frequent portfolio reconciliations and mark-to-market comparisons, including on collateralized instruments."

This recommendation refers to the practice, at the time of the CRMPGIII paper not consistently adopted across the OTC derivative market, of two parties to a transaction performing a periodic portfolio reconciliation between their respective records to ensure that (a) the parties agree the existence and general economic terms of the transaction in question, and (b) that they agree the mark-to-market value of the transaction, within reasonable tolerance[2].

Since publication of CRMPG III, the practice of collateralised portfolio reconciliation has undoubtedly become more widespread in the OTC market. Many Buy-Side firms have for some time used this discipline to regularly reconcile their portfolios against dealers, prime brokers and custodians, amongst others. Since 2008, Major Broker Dealers have undertaken commitments to regulators to reconcile portfolios between themselves, initially weekly for portfolios over 5,000 trades and reducing, using a phased approach, to daily reconciliations of portfolios over 500 trades today. This daily reconciliation activity is now estimated to account for some 65% of total OTC market volume.

1.2 Objective

The objective of this Implementation Plan is to draw upon the body of work set out in the Feasibility Study to recommend a phased approach to extending the discipline of portfolio reconciliation as best practice throughout the OTC market, giving consideration to any infrastructure and standardisation of practices which may be needed to support this. As discussed in the Feasibility Study, extending frequent portfolio reconciliation to all clients may not be the most efficient alternative, particularly for small-size OTC portfolios which are not actively traded; in such cases, other solutions for maintaining portfolio integrity should potentially be considered.

1.3 Scope

The scope of this Implementation Plan (and any capitalised terms used in this document including the definition of Collateralised Portfolio Reconciliation) is consistent with that set out in the Feasibility Study.

---

[1] Containing Systemic Risk: The Road to Reform, Counterparty Risk Management Group III, August 6, 2008, New York

[2] In theory the mark-to-market value of a transaction between two parties will be x from the perspective of one party and $-x$ from the perspective of the other. For various technical reasons, the exactness of this equivalence breaks down in practice, but nevertheless the valuations of the two parties should be reasonably consistent. If they differ materially, this is an indication that the parties either have a valuation methodology difference or some mismatch in the inputs they are using for their valuation processes; in either case, this can lead to disputed margin calls, uncertainty as to credit exposure and difficulty in agreeing termination values.

ISDA®
International Swaps and Derivatives Association, Inc.

1.4 Summary Recommendations from the Feasibility Study

The Feasibility Study made the following recommendations to be considered as part of this Implementation Plan:

Recommendation 1

OTC derivative market participants should adopt the Collateralised Portfolio Reconciliation Best Practices

Recommendation 2

OTC derivative market participants should adopt the Minimum Market Standards for Collateralised Portfolio Reconciliation

Recommendation 3

ISDA should commission an Implementation Plan to develop a graduated approach to wider market adoption of Portfolio Integrity Assurance measures. It is recommended that the plan should be developed to address:

- Adoption of a regular portfolio reconciliation discipline for actively traded portfolios with counterparties trading OTC derivatives as principal, for hedging and for investment purposes. This is principally directed to the Major Broker Dealers[3], Other Banks and Buy-Side firms.
- Adoption of a periodic portfolio reconciliation discipline for counterparties with less actively traded portfolios, principally directed to End-Users.
- Exclusion of small size portfolios where there is infrequent trading activity from the requirements of formal portfolio reconciliation. This is principally directed towards End-Users. For these portfolios, annual provision of a position and valuation statement by the dealer firm, which enables the counterparty to verify the portfolio population may be a more appropriate approach.

1.5 Dependencies identified by the Feasibility Study

A number of factors were identified as having a potential impact to extending collateralised portfolio reconciliation more widely in the OTC market. The issues listed below are discussed in more detail in the Feasibility Study and have been considered in developing ths Implementation Plan.

Reconciliation Technology
Common Data Standards & Consistency
Scalability
Transparency
Inter-Operability
Reconciliation Frequency
Bi-Lateral Commitment & Shared Responsibility
Resourcing
ISDA Dispute Resolution Procedures
Future Market Developments

[3] Portfolios between the Major Broker Dealers are already subject to daily portfolio reconciliation. This recommendation is focused on portfolios between derivative dealers (G 14 Dealer and Other Banks and Buy-Side firm)s, where stronger harmonization of market practice and reconciliation frequency may be helpful

1.6 Consultation Process

In arriving at the recommendations set out in this paper, a discussion and consultation process at practitioner level took place inviting all Collateral Roadmap signatories. The recommendations have been presented to, and approved by, the ISDA Collateral Steering Committee and the ISDA Industry Governance Committee. This paper and its recommendations have been presented to the ISDA Collateral Portfolio Reconciliations working group which has wide industry representation from some 200 members, and communicated to the ISDA Collateral Committee via its regular update forum.

2 Implementation Plan Recommendations

2.1 Considerations

The Collateral Roadmap signatories have aimed to devise a path by which steps to reconcile regularly with a broader range of counterparties can be achieved within a short timeframe, whilst allowing opportunity for a greater degree of market standardisation to be implemented and supporting technology services to be developed.

There is a clear view amongst firms which already reconcile regularly that their technology choices should be respected. This is an important factor to take into account as firms have developed internal workflows and processes to support efficiency, scalability and automation of the process which will need to be maintained in a higher-volume environment**.** To enable maximum flexibility, it should be possible for both parties to perform a reconciliation if required.

Undoubtedly a drive for greater standardisation will do much to support increased volumes. The Collateralised Portfolio Reconciliation Best Practices and data Market Minimum Standards (MMS) serve to guide the OTC market in this respect. Adoption of these, as recommended in Section 2.4, is an important step forward in promoting the wider use of portfolio reconciliation. It may be that vendor services could be developed which, at a realistic cost, could normalise data to MMS standards for less active market participants and relieve expensive technology changes to internal OTC systems.

Questions around inter-operability of in-house technology and vendor platforms for both file exchange on reconciliation and gaining a shared bi-lateral view of results are not easy issues to solve for. Recommendations in Section 2.4 below propose that a dialogue be developed with vendors throughout 2010 which would allow for appropriate solutions to be designed and developed.

An expansion in reconciliation volumes where OTC participants are using different technology platforms (both in-house and vendor-serviced) brings into sharp focus that files for reconciliation will need to be transmitted across the market and this is most likely to occur by the most available route, ie by email, in the majority of cases. The potential for breaches of security in client data are considered to be significant. With the advent of electronic messaging, more secure channels are becoming available. Counterparties may transfer files between them by setting up secure FTP connections where this requirement is a regular occurrence. However, market vendors could potentially add value in this connection for less frequent users as part of their commercial services.

As the market changes and evolves with new central counterparties being developed, trade repositories and golden source data held on external platforms, it may be that the nature of collateralised portfolio reconciliation will in itself change over time. In this respect, it would not seem prudent to go too far too fast in recommending market infrastructure changes or a market model for portfolio reconciliation until the picture of requirements becomes clear. The recommendations made in this Implementation Plan should be considered in this context.

2.2 Portfolio Reconciliation Market Roll-Out – Phase I

The following recommendations relate to the initial phase of rollout for portfolio reconciliation activities across the wider market in 2010 and are seen as minimum commitments.

There should be an attempt to unilaterally reconcile any portfolio based on the following parameters:

- Collateralised portfolios with any OTC counterparty comprising more than 1,000 trades should be reconciled at least monthly by June 30, 2010[4]

- Both parties should provide a portfolio data file to a pre-agreed schedule without further request, and should be able to provide sufficient data (inclusive of NPVs by trade) in that file to a quality standard which enables the file to be readily reconciled. If a file is not provided promptly, or is not provided to a satisfactory standard, it cannot be reconciled.

- Each party to be able to reconcile on a platform or technology of their choice (vendor managed or in-house infrastructure)

- Each party to provide results on request in a mutually agreed form

- To maintain efficiency, scalability and security of the process, counterparties will need to mutually agree a method of secure data delivery which should be to the destination of each party's choice.

- The Major Broker Dealers will expand current monthly Portfolio Reconciliation reports submitted to their regulators to reflect the above commitment by July 31, 2010

In making these recommendations, it is recognised that many potential impacts identified in the Feasibility Study have not been addressed. As volumes of files for reconciliation increase using multiple technologies and platforms, the issues outlined in Section 1.5 and discussed in more detail in the Feasibility Study will potentially crystallise for action. The key considerations will be to maintain integrity, scalability, efficiency and automation of the existing process.

2.3 Portfolio Reconciliation Market Roll-Out – Phase II

Industry participants recommend that the results of the Phase I rollout should be studied in the months following the June 30, 2010 implementation. This period of evaluation is considered critical for two main reasons:

(a) **To gauge the level of market take-up and readiness:** as portfolio reconciliation practice is rolled out to increasingly diverse and numerous market participants, implementation of the process may impact businesses which typically do not have the staff or technology resources of larger market participants. As a result, those businesses may be more susceptible to disruption by such implementations, and lead to shortfalls in the level of cooperation or other factors which may need to be addressed in the light of experience.

(b) **To gauge the need for market infrastructure and standardisation:** it will be important to assess what market infrastructure and standardisation requirements are in place and are still needed for Phase II to maintain integrity, efficiency, scalability and security of the

[4] Commitment does not include inter-company trades (ie between affiliates of the same group), internal trades (ie between desks/locations of the same firm) or any portfolios of trades held with CCPs. Additionally CSAs comprising only spot FX trades are excluded since FX trades mainly settle through CLS which already reconciles open positions on a daily basis. Portfolios are assessed at CSA level. Phase I includes Asset/Fund manager CSAs if individual funds exceed 1,000 trades. Asset/Fund Manager CSAs covering multiple funds with individual portfolio sizes below 1,000 trades are not intended to be captured within Phase I.

process. This is seen as having the highest impact on Major Broker-Dealers which will experience significantly increased volumes.

Therefore it is recommended that a detailed Phase I review be conducted by December 31, 2010 with a view to using the results to implement Phase II as part of the industry agenda for 2011.

Based on this review, timing for Phase II targets set out below should be determined in relation to:
.
- A decision to increase the frequency of reconciling individual collateralised portfolios over 1,000 trades from a minimum of monthly to weekly

- A decision around expanding commitments to reconcile any collateralised portfolio comprising more than 500 trades at least monthly

- A decision around expanding commitments to reconcile collateralised portfolios comprising more than 1,000 trades across multiple funds at the Credit Support Annex (CSA) level with Buy-Side firms at least monthly

An assessment of requirements which will allow introduction of periodic reconciliation of portfolios with less than 500 trades should follow the Phase II implementation.

2.4 Portfolio Reconciliation Market Roll-Out – Supporting Recommendations

The recommendations set out below are highlighted for consideration by the ISDA Collateral Steering Committee and the ISDA Collateral Infrastructure Working Group. These may not be exhaustive of all issues which, in the light of practical experience, may be deemed to have a material impact. These recommendations particularly apply in relation to Phase II.

- There should be consideration as to whether the market can move towards a bilateral view of reconciliation results at some future stage. This inter-alia would involve working with vendors to obtain a satisfactory degree of inter-operability.

- Files for reconciliation should comply with Minimum Market Standards for Collateralised Portfolio Reconciliation and the market should adopt the Collateralised Portfolio Reconciliation Best Practices.

- If sufficient demand develops, vendor services could be encouraged to support normalising of data to MMS standards.

- Potential development of secure data transfer options should be encouraged with vendors to mitigate breeches of security for client data and eliminate the practice of email exchange for reconciliation files.