The ‘Risk Metrics’ Sub-Group of the ISDA Operations Committee – Metrics Working Group

Prioritising among outstanding confirmations or payment breaks

Introduction

The Sub-Group sought to publish a consensus view on systematic approaches to prioritising among remedial work on trade confirmations and payments processing. In so doing, the Group intended to promote awareness of the issues and broader discussion of them in the market.

As the optimal strategy for the future, the OTC derivatives industry remains committed to maximising automation – via FpML-based solutions – of trade processing. (This may entail ‘affirmation’ at the time of trade, as distinct from ‘confirmation’ after it.) Firms do, however, also recognise the need to deal in an orderly way with any build-up of outstanding confirmations that may have already occurred or that may occur in future. Such a situation may occur because of volume growth, particularly in new instruments for which automation may not yet be available, bearing in mind that OTC derivatives are characterised by their ability to be tailored to individual clients’ requirements.

While an oral contract between counterparties is legally binding, an absence of clearly documented agreed terms to an individual deal is undesirable. It creates operational uncertainty, leading to potential inefficiencies in the event of an insolvency and, even in the absence of an insolvency, potentially to a cash impact (if failed or incorrect settlement or delivery ensues). This creates extra work (to resolve the discrepancy), reducing profit margins. A failed or incorrect settlement/delivery may constitute not only an immediate “break” but also a concern in relation to future obligations.

Effectively, the Sub-Group has worked on ‘key indicators’ for the OTC-derivatives operations field. Specifically, it arrived at a set of criteria or factors for market participants to consider using in determining a scoring system, based on a level of “significance” attaching to:

(i) any given outstanding confirmation; or
(ii) non-receipt of an individual payment or delivery.

The “significance” factors that the Group proposes are criteria that a number of market participants consider relevant in distinguishing among any group of outstanding confirmations or payment “breaks”. They may indicate *either*:

the level of doubt that the delinquency might cast upon the general certainty of the parties as to the terms of the transaction, and potentially future performance; *or*

the impact, should there be failure to perform in any way.

One of the factors – counterparty credit risk rating – simply reflects the counterparty’s probability of default. The more likely a counterparty’s default, the more chance an entity facing that counterparty will need to resolve its position with regards to transactions that are open with that counterparty, for which purpose having clear transaction documentation to hand will be of value.

In no way are the suggestions below intended to supplant or replace any existing risk management processes within firms; to the extent that firms wish to utilise such criteria, they are intended to support operations and, as such, greater efficiency in determining positions.

Significance factors

Neither of the lists below is ranked in order of importance. A party could ascribe a weighting to each of the factors, and a value for that particular factor in relation to each ‘item’ (ie, each outstanding confirmation or failed payment). This would allow it to arrive at an overall “score” for each item. It is envisaged that each firm will determine its own weightings and values but that, in general, “scoring” items in this way will allow them to prioritise workflows and to deploy resources accordingly.

The following four common criteria were viewed as **Primary**:

- The counterparty has either denied the transaction’s **existence** (“DK’ed” the trade) or it has become clear that **disagreement exists** between the parties as to the major economic terms of the transaction.
- **Present value** – clearly the more positive, the greater the severity, should any loss be crystallised.
- **Age** – bands of 6-30, 31-60, 61-90 and 90+ calendar days from Trade Date were agreed upon.
- **Counterparty credit risk rating**.

<u>The following eight common factors were viewed as **Secondary**</u> (ie, their usefulness will be dependent upon the nature of that firm's business mix and operational processes).

- **Broker confirmation** – if one is in hand, this provides a measure of independent confirmation.
- **Type of counterparty** – a deal between a professional and less sophisticated end-user may involve complex legal considerations such as suitability and capacity.
- **Collateral** – is collateral against the deal validly held?
- **Tapes** – although parties should be aware of potential difficulties in locating conversations and of short retention periods.
- The **country of incorporation of the counterparty** – country risk.
- The **governing law** of the documentation at relationship and trade level.
- **History** of poor confirmations/payments performance by the counterparty – this may well adversely impact a counterparty's overall scoring.

Plus either:

<u>A) for outstanding confirmations:</u>

(i) **Workflow status** - has the firm issued the confirmation yet?
(ii) **Cashflows or deliveries** – if any cashflow or delivery has occurred this would tend to corroborate the existence of a transaction. Conversely, where a cashflow or delivery was expected, but not received, causing a reconciliation break on the Nostro/physicals account, this break should escalate an item's score.

Or:

<u>B) for outstanding or incorrect settlements or deliveries:</u>

(i) **'Workflow' status** – has the payor/delivering party been advised of the failed settlement/delivery?
(ii) **I**s there an **agreed trade confirmation?** If not, this should escalate an item's score.
(iii) **Is it an outright non-payment/delivery**, (ie, zero) or an incorrect amount?
(iv) Is the item **internal** (intra-company/intra-group) **or external?**
(v) Is there a **signed master agreement?**

<u>Conclusion</u>

In conclusion this paper suggests an approach towards establishing scoring systems to distinguish among outstanding confirmations and among failed settlements. It highlights four components of composite indicators that the Sub-Group deemed primary, and a number of other components that firms could consider using additionally, in order to produce an overall indicator that is broadly effective in assessing the magnitude of 'operations risk'. The Group encourages firms to consider this kind of approach, using a composite metric for each of the confirmation and settlement elements of the overall operations process.

Furthermore, if use of such approaches broadens and develops as the Sub-Group anticipates, ISDA will attempt to track this in its annual Operations Benchmarking Survey. In the meantime, the annual Operations Benchmarking Survey provides an overview of industry performance in the field of OTC derivatives operations, highlighting such indicators as average industry confirmation backlogs.

<u>Explanatory note on risk</u>

A key premise of this paper is the distinction that must be made between managing 'operations risk' on the one hand and, on the other, credit risk and market risk.

Credit risk ratings seek to quantify the risk of counterparty's default. Exposure to a counterparty crystallises as a result of a default that renders that counterparty incapable of making payments or deliveries, whether due at the date of default or payable/deliverable at a future date. Market risk arises from fluctuations in the value of positions, and can accordingly give rise to ('counterparty') credit exposure.

The mere fact that a confirmation relating to a trade with a given counterparty remains unsigned clearly does not, in itself, indicate that the counterparty is any more likely to default, or that a market value will change. (It may conceivably turn out that operational inefficiencies accompany other failings that ultimately contribute to a counterparty's demise. But a failure to sign a confirmation cannot, per se, be assumed to indicate a greater probability of default.)

Even upon default, an oral contract will be enforceable. However, for the purposes of day-to-day operations as well as for the situation when a counterparty becomes insolvent, an ability to quickly and accurately check as to the details of transactions are open with that counterparty is clearly important, and provides a particularly strong form of evidence as to the terms of a deal.

Alternatively, even if the counterparty does not default, a position may have to be reversed, perhaps because of a mis-booking. In such circumstances, a position that had been assumed to be out-of-the money would now entail a credit exposure (against which, under the normal operation of its credit policy, a firm might have sought collateral). An in-the-money position, once reversed, would of course no longer represent a credit exposure on the counterparty. However, any related hedge might have to be unwound, and a loss might be crystallised on that transaction.

A failed or incorrect settlement or delivery represents an immediate realisation of settlement exposure to the counterparty and remains an outstanding “break” until settled/delivered. In and of itself, however, a failure to settle/deliver when due does not necessarily connote that the counterparty is likely to default on its obligations more generally, as the payment or delivery failure may well be due to an operational error or omission.