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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;

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

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

MTM Diff = abs (MTM B + MTM A)

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

MTM Diff = abs (MTM B + MTM A)

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
Cpty A	(40,000,000)		
		100,000,000	3
Cpty B	35,000,000		

Calculations:

MTM Diff = abs (35,000,000 + (40,000,000)) = 5,000,000 ----> Is below absolute 10 million threshold.

$$\text{Basis Points} = \frac{5{,}000{,}000}{100{,}000{,}000 * 3} * 10000 = 166.7$$

----> 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
Cpty A	(40,000,000)		
		100,000,000	3
Cpty B	25,000,000		

Calculations:

MTM Diff = abs (25,000,000 + (40,000,000)) = 15,000,000 ----> Is above absolute 10 million threshold.

$$\text{Basis Points} = \frac{15{,}000{,}000}{100{,}000{,}000 * 3} * 10000 = 500.0$$

----> 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
Cpty A	(40,000,000)		
		100,000,000	40
Cpty B	25,000,000		

Calculations:

MTM Diff = abs (25,000,000 + (40,000,000)) = 15,000,000 ----> Is above absolute 10 million threshold.

$$\text{Basis Points} = \frac{15{,}000{,}000}{100{,}000{,}000 * \#} * 10000 = 37.5$$

----> 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
Cpty A	(50,000,000)	
		50,000,000
Cpty B	18,000,000	

Calculations					Results	
MTM Diff = abs (	18,000,000	+	(50,000,000)	) =	32,000,000	----> Is above absolute 10 million threshold.
Pct of Notional =	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
Cpty A	(50,000,000)	
		500,000,000
Cpty B	18,000,000	

Calculations					Results	
MTM Diff = abs (	18,000,000	+	(50,000,000)	) =	32,000,000	----> Is above absolute 10 million threshold.
Pct of Notional =	32,000,000 / 500,000,000	*	100	=	6.4%	----> Is below relative (10%) threshold

Not counted as supervisory Valuation Difference