Credit Derivatives Market

Credit Steering Committee
The Credit Steering Committee is a newly formed industry wide committee with contributors across trading, legal and operations from the Major Dealers and buy-side participants.

Single Name Trade Compression Mechanics
The Major Dealers have developed a new product to achieve single-name trade compression. Existing single-name trades will be compressed into two trades (a plain-vanilla CDS with a coupon determined by a weighted average of the coupons of and a net notional of the compressed trades, and an interest only swap (in effect, a fixed recovery swap with a recovery of 100%).

Auction Hardwiring & Credit Event Protocol
In relation to the process of incorporating the auction mechanism into the ISDA Credit Derivatives Definitions, ISDA reported to supervisors at the June 9 meeting that the working group had taken the decision to move forward, as a first step, with that part of the hardwiring process that will have the greatest impact in a relatively short timeframe. The group will therefore first focus on an Auction Supplement that addresses “Failure to Pay” and “Bankruptcy” Credit Events in respect of North American and European corporates, leaving “Restructuring” Credit Events to be addressed at a later date. A separate working group is addressing the settlement of potential monoline defaults in parallel.

The Auction Supplement will be published concurrently with a “big bang” protocol to allow all market participants to amend their existing CDS trades to utilize the auction mechanism. ISDA has committed to supervisors that it will circulate a first public draft of the Auction Supplement in August and a first public draft of the big-bang protocol in September. Work has already commenced on the Auction Supplement; ISDA expects publication by December 31, 2008.

Equity Derivatives Market

Electronic Matching Deal Volume
Electronic matching deal volume refers to the total number of eligible Equity Derivative trades transacted each month. This volume is based on absolute numbers where one deal equals one confirmation.

“Electronically eligible, confirmable transaction” volume includes the following events:
  Variance Swaps
    o 1 Variance Swap = 1 deal = 1 Confirmation
    o 1 Termination = 1 deal = 1 Confirmation
  Options
    o 1 Option trade = 1 deal = 1 Confirmation
    o 1 Upsize / Increase = 1 deal = 1 Confirmation
    o 1 Partial Termination / Partial Unwind = 1 Confirmation
    o 1 Termination = 1 deal = 1 Confirmation
  Both Products
    o 1 trade with Parent = X Fund Allocations = X deals in Deal Volume = X Confirmations
    o All external-facing business deals

“Electronically eligible, confirmable transaction” volume excludes the following events:
  Variance Swaps
    o Partial Terminations
  Both Products
    o Novations (which are not yet supported on an electronic confirmation platform)
    o Business Events such as Option Expiries and Corporate Actions
All amendments or modifications to existing electronically eligible confirmable events (these should be confirmed electronically but are not part of the volume count)
- Any events originally confirmed on paper and all related subsequent events
- All inter-company or intra-desk trades, even those for which a confirmation is required

Best Practices for Collateralized Portfolio Reconciliation

ISDA Best Practice Guidance for Reconciliation of Collateralized Portfolios Between Derivative Market Professionals - July 2008
(Draft Version-Final Publication Expected Imminently)

Preamble

In the normal course of operating collateral agreements such as the ISDA Credit Support Annexes, counterparties will occasionally find that a collateral call cannot be agreed, due to disagreement in relation to the value of the Exposure of the portfolio of transactions between them. Accordingly market practice has developed whereby often counterparties will attempt to reconcile the population of trades in their portfolio and the mark-to-market values of those trades.

It has been noted by collateral practitioners that, especially during recent periods of volatility, the frequency of occurrence, size and longevity of disputed collateral calls have all increased. This is most notably so for transaction portfolios between large dealers. In many of these cases, in addition to trade-population volatility caused by trading activity and trade-valuation volatility caused by market factors, the size of portfolios has grown large over time and this sheer scale has impeded the process of collateralized-portfolio reconciliation.

ISDA notes that the efficient functioning of the derivatives market and the effective management of risk are both well-served if counterparties are able to identify portfolio mismatches and resolve disputed margin calls rapidly, and to subsequently settle collateral movements. Working through the ISDA Collateral Committee, collateral practitioners from a wide variety of firms across the market have reviewed the current state of market practice relating to portfolio reconciliation, and also considered appropriate goals to which industry participants may aspire. While daily portfolio reconciliations between market professionals should be a strategic goal for the industry, the guidance below reflects a set of best practices that are pragmatic within a reasonable time frame. These best practice levels may be a significant ‘stretch’ for some market participants, but their consistent accomplishment across the market professional community would lead to a material improvement over current operational and risk management practice in the collateral management area, and should form a basis for further advances in the future.

It should be noted that the proposals below are framed primarily for derivative dealers but this is not intended to exclude discussions as to their potential relevance to other market participants.

Best Practice Guidance

ISDA recommends best practice amongst market professionals as follows:

1. For portfolios of OTC derivatives documented under an ISDA Master Agreement and Credit Support Annex between a firm and another market professional numbering greater than 5,000 transactions (see Note 1) outstanding:
   a. Firms should perform regular trade-level reconciliation of (a) trade population and (b) trade mark-to-market (see Note 2).
   b. The matching process for trade level mark-to-market values may employ a tolerance level for differences, below which the difference is ignored in order to filter out background noise that is immaterial to agreeing a collateral call. Counterparties should choose an appropriate tolerance level as they consider appropriate based on the materiality of differences relative to the complexity, risk and size of the portfolio.
   c. The recommended portfolio reconciliations between market professional firms should take place once per week; firms may elect to perform them every 2 weeks or once per month as an interim step towards the goal of a weekly reconciliation.
2. Firms performing portfolio reconciliations should ensure that they have **sufficient infrastructure and resources** to enable them:
   a. To perform the portfolio reconciliation and isolate mis-matched trades within a reasonable time of a material collateral call dispute arising (see Note 3).
   b. To investigate and resolve mis-matches within a reasonable period of time of their identification and isolation (see Note 4).

3. Firms should establish formal written procedures to ensure that the existence of material trade population and mark-to-market differences, if not otherwise resolved, are **escalated** to senior trading desk personnel to facilitate:
   a. Senior review of mark-to-market value differences and adjustment if appropriate.
   b. If differences cannot be resolved by unilateral adjustment, then timely desk-head-to-desk-head communication between firms to pursue mutual resolution of material differences.

4. Firms should maintain **statistical information** regarding counterparty portfolio match rates. This information should be shared with internal risk management forums and also made available bilaterally between a firm and its applicable supervisors. The core elements of such data should adhere to common standards of definition and presentation (which ISDA will set out in a forthcoming annex to this document) in order to facilitate confidential comparison by supervisors across the market as a whole.

The foregoing best practice recommendations are advisory and non-binding – firms should employ their own discretion in relation to relevant risk factors in deciding whether, or to what extent, to adhere to these guidelines.

**Further Commentary**

**Note 1**
The 5,000 transaction threshold includes all trade types and asset classes documented under the relevant ISDA Master Agreement and Credit Support Annex. It should be noted that this threshold was chosen as a simple and convenient way to differentiate larger portfolios from smaller portfolios, however this should not imply in any way that portfolios below this size should not be subject to regular portfolio reconciliation. Counterparties should use their judgment of the complexity and risk of a portfolio as well as its size in determining a prudent approach to portfolio reconciliation.

**Note 2**
The purpose of collateralized portfolio reconciliation is to accomplish sufficient congruity of trade population and valuation between the counterparties so as to permit a collateral call to be agreed and settled. The purpose is not to achieve a perfectly matched reconciliation of trade-level mark-to-market values, which may legitimately differ between the parties. Accordingly, counterparties may perform portfolio reconciliation and follow-up investigation only to the extent necessary to agree a collateral call, and need not pursue the goal of an exhaustive portfolio match (although they may of course elect to do the latter for reasons of their own).

**Note 3**
The reasonableness of the time to identify and isolate issues will vary according to the size and complexity of a particular counterparty portfolio, and should comply within the context of the relevant Credit Support Annex between the parties that sets forth certain timing constraints around the disputation of margin calls.

**Note 4**
The reasonableness of the time to resolve issues will vary according to the size, complexity and credit risk of a particular counterparty portfolio, and importantly whether or not a collateral call dispute currently exists. While mismatches in the portfolio composition between the parties may be resolved as a matter of fact within a short period of being identified, other more complex issues, especially those having to do with valuation mismatches, may take an extended period of time to resolve between the parties.