Portfolio Reconciliation and Dispute Resolution

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February 14, 2011

What is an OTC Derivative Margin "Dispute" ?

Under the Credit Support Annex, "dispute" has a particular technical meaning. A disputed margin call may not be cause for concern.

- "Dispute" is an emotive term. The dictionary definition is:
  1. to engage in argument or debate
  2. to argue vehemently; wrangle or quarrel
- Under the ISDA Credit Support Annex we use the term "dispute" to simply indicate where two parties have been unable to fully agree a margin call.
- At the point the margin call is disputed, the parties will not have examined the substance of the call.
- Many disputes spontaneously disappear in a short period of time, and many are economically insignificant (see next page).
- There is a technical reason why one must "dispute" a margin call if it cannot be fully agreed. Under the ISDA Master Agreement failure to deliver collateral on demand may be an event of default, but the act of disputing a margin call provides contractual protection against being declared in default, while the investigation is ongoing.

Scenario 1 - Fully Agreed Margin Call

Party A

Party A calls Party B for $10 of collateral.
Party B agrees the call. $10 collateral moves.

Party B

Scenario 2 - Partially Agreed Margin Call (Small Disputed Amount)

Party A

Party A calls Party B for $10 of collateral.
Party B agrees to $9 of the call and disputes the remaining $1. $9 collateral moves and the parties may pursue their dispute resolution options or "agree to disagree" on the remaining $1, holding additional capital instead.

Party B

Scenario 3 - Partially Agreed Margin Call (Large Disputed Amount)

Party A

Party A calls Party B for $10 of collateral.
Party B agrees to $2 of the call and disputes the remaining $8. $2 collateral moves and the parties may pursue their dispute resolution options (technically they may also "agree to disagree" on the remaining $8, holding additional capital instead, but this would be rare for a large disputed amount).

Party B

Scenario 4 - Fully Disputed Margin Call (with Counter-Call)

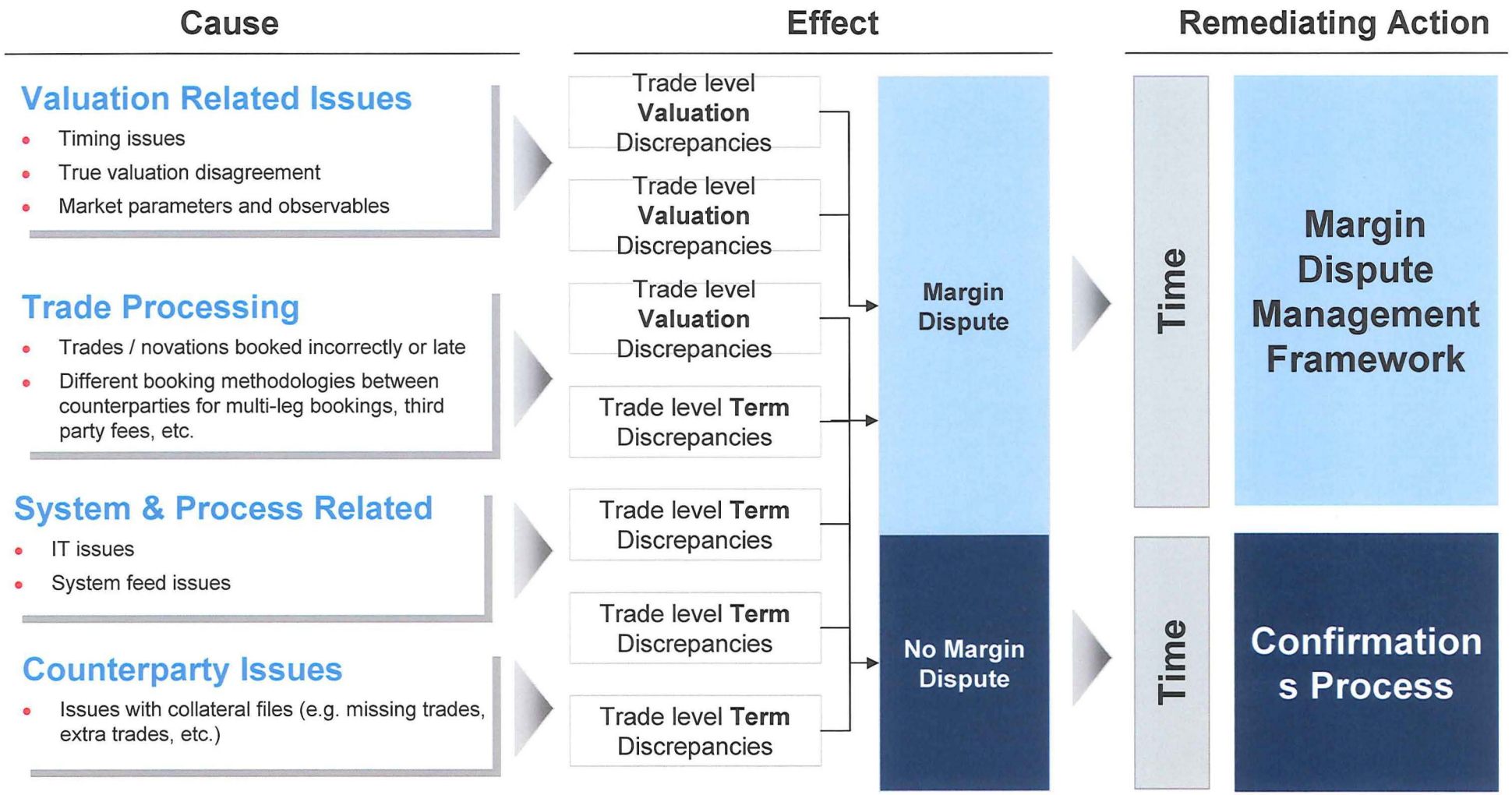
Party A

Party A calls Party B for $10 of collateral.
Party B counter-calls Party B for $4 of collateral.
Both Parties dispute the call of the other party.
No collateral moves and the parties may pursue their dispute resolution options (technically they may also not pursue their calls against one another, holding additional capital instead, but this would be rare for a fully disputed or call/counter-call scenario).

Party B

What are the Root Causes of Margin Disputes?

Margin disputes may occur for several reasons, only some of which give rise to economic risk



Key distinction: Trade level valuation discrepancies <u>in the absence of a margin dispute</u> have no economic consequence - they are just <u>temporal mismatches</u> between internal records of <u>unrealized</u> gains. Industry focus is on <u>differences with economic significance - especially disputed margin calls</u>

ISDA Margin Dispute Management Framework

Since 2008, working in collaboration with the ODSG*, the industry has developed a multi-layered approach to managing margin disputes

	Internal Firm Practice	Firm to Firm Industry Practice	Legislation / Rulemakings	Regulatory Capital	Commitments
Avoidance (Portfolio Reconciliation)		✓	✓		✓
Prompt Investigation	✓	✓			
Escalation	✓	✓			
Transparency	✓				✓
Resolution	✓	✓ Methodology	✓ Timing	✓ Economic Consequence	
Intractable Dispute Management	✓	✓ Methodology	✓ Timing	✓ Economic Consequence	

* OTC Derivatives Supervisors Group

Dispute Avoidance - Portfolio Reconciliation

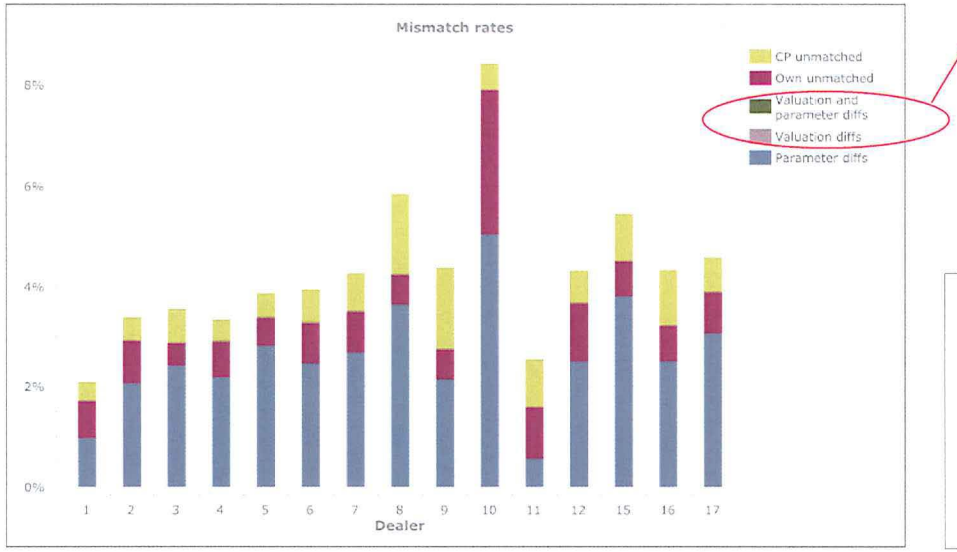
The ISDA Dispute Management Framework has been highly successful in reducing difference and disputes

Current Practice

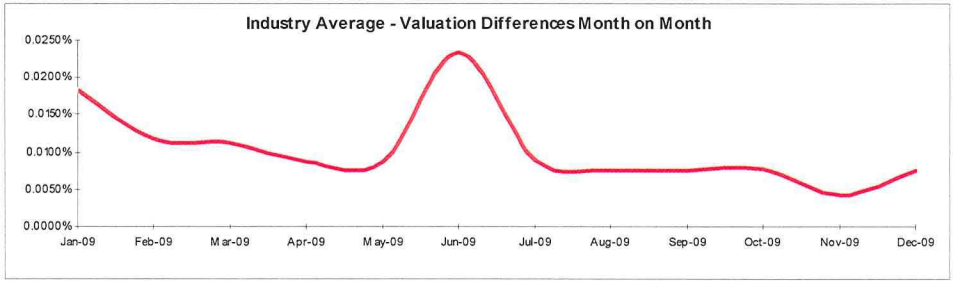
- Daily Portfolio Reconciliations between G14 (June 2009)
- Portfolio Reconciliation between G14 and their counterparties with >1,000 trades (July 2010)
- APAC Portfolio Reconciliation Memorandum of Understanding (January 2011)

I.B Enhanced reporting: Mismatch rates with G14 dealer counterparties

CSA:s with more than 500 trades are included
Volume weighted average values



The percentage of valuation differences in the overall portfolio is relatively small when compared with term discrepancies. Below is a chart depicting the levels of valuation differences month on month throughout 2009.



Monthly reports provided to the supervisors on G14 portfolio reconciliation results show valuation differences are minimal

Historical trend of valuation differences throughout 2009 show that at its peak, valuation differences made up only 0.025% of overall portfolios.

Note: The spike in June is a data collection artifact attributed to the reporting changes that were implemented:
- Moved from a $20mm threshold to a risk based threshold per product
- Moved from reconciling portfolios of >5,000 trade to >500 trades

ISDA Margin Dispute Convention and MPP Drafts

The final part of the ISDA Dispute Management Framework is the creation of market standard documentation to govern the investigation and resolution of truly disputed margin calls - this is Work-in-Progress.

- **2010 Convention Draft – 30 Calendar Days**
  - Daily use during business as usual circumstances
  - Method for investigating disputed portfolios; includes steps such as
    - performing a portfolio reconciliation
    - identifying transactions driving the dispute
    - senior level escalation and discussion (intra and inter-firm) as needed.
  - 30 days has been debated extensively, but is necessary because the time period must allow for:
    - Time to obtain both parties' data to reconcile
    - Time to perform the reconciliation and study the results
    - Time to investigate results of interest, which may involve different desks and timezones. Some investigations are complex and take several days
    - Time to review with senior management and obtain necessary risk, accounting, legal, trading and other approvals for P&L adjustments
    - Time for senior consultation between firms to occur, which may involve individuals with intensive schedules, who may be travelling and who may be in different timezones.
    - Note that *in extremis* the 30 day period can be accelerated to zero days, with the MPP invoked immediately.

- **2010 Market Polling Procedure (MPP) Draft– 18 Local Business Hours**
  - Lays out the procedure and conduct for disputing parties to execute a Market Poll
    - Evaluation gives precedence to two-way, firm, executable quotes
    - Evaluation attempts to synthesize the real market (tightest bid and offer)
    - Results are bound by the Mid Market Values and Executable Quotes (if any)
    - The MPP will always lead mechanically to a result, although in the absence of any independent values and with neither party willing to make a firm , executable price the result may be based on splitting the difference between the views of the counterparties.
  - The MPP is a complex and intensive process that is not intended to be used frequently or for large numbers of transactions.
  - Disputing parties are strongly encouraged to resolve their differences consensually under the Convention.

NOTE : DETAILS SUBJECT TO CHANGE

Annex 1 : Overview of the Convention and MPP Drafts

Disputed Margin Call

Move Undisputed Collateral*

Convention: 30 Calendar Days (max)

D

Administrative Review (20 Calendar Days)
- Promptly exchange portfolio data (Mandatory)
- Perform a portfolio reconciliation
- Investigate the dispute and consult with each other as to that investigation
- Any disputes unresolved after 20 Calendar Days goes to Senior Consultation, in addition to continuing the Administrative Review

D + 19

D + 20

Senior Consultation (10 Calendar Days)
- Either party may deliver a Senior Consultation Selection Notice
- Senior level escalation and senior level firm-to-firm discussions as needed
- Any disputes unresolved after 10 Calendar Days goes to Market Polling

D + 29

ISDA CSA New York Law - Paragraph 5. Dispute Resolution at the **Notification Time**

OR

ISDA CSA English Law - Paragraph 4. Dispute Resolution - at the **Notification Time**

Move Additional Collateral for Consensually Resolved through Convention*

Market Polling Procedure: 18 Local Business Hours (LBH) (max)

D + 30

Polling Process Consultation (2 Local Business Hours)
- Disputing Party initiates via telephone and written notice to other Party's Senior Official
- Each Party will:
  - Identify Reference Independent Price Sources (RIPS) it intends to solicit for Quotes
  - Agree Announcement Time; default is6 LBH after Quote Gathering Starts
  - Agree Transaction Size; default is commercially reasonable

D+30 + 2LBH

Quote Gathering (at Announcement Time - 6LBH is default)
- Each Party may solicit as many Quotes as it wishes from the RIPS
- At the end of Quote Gathering, each Party must submit (as of Announcement Time):
  - Their Mid-Market Value
  - Optionally their Executable Quote
  - All the Quotes obtained from the solicited RIPS (Executable or Indicative)

D+30 + 8LBH

Quote Evaluation (6 Local Business Hours)
- Collated Quotes are evaluated to determine the Result
- There are 3 possible scenarios
  - Two or More Executable Quotes
  - One Executable Quote
  - No Executable Quotes

D+30 + 14LBH

ISDA CSA New York Law - Paragraph 5. Dispute Resolution at the **[Resolution Time]**

OR

ISDA CSA English Law - Paragraph 4. Dispute Resolution - at the **[Resolution Time]**

MPP Result Obtained

Move Additional Collateral*

**Failure to Move Collateral Results in an Event of Default*