Balancing Operational Efficiencies and Regulatory Controls Within a Changing Derivatives Market Place

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Topics

1	Purpose of Confirmations
2	Enhancing Confirmation Processes
3	Confirmation and Close-out Netting
4	Unauthorised Transfers

Purpose of Confirmations

- The main purpose of confirmations is to provide evidence of the entering into a binding transaction and its content.
- Evidence is needed in legal proceedings or in a counterparty's insolvency if the existence or the content of a transaction is disputed.

> ISDA 2002 Master Agreement, Section 9(e)(ii):
> "*… a Confirmation will be entered into as soon as practicable and will be executed […] by an exchange of telex, by an exchange of electronic messages or an electronic messaging system or by an exchange of e-mails, which in each case will be sufficient for all purposes to evidence a binding supplement to this Agreement.*"

- Confirmations are better than recorded tapes or witnesses.
- A backlog in the confirmation process compromises the credit institution's ability to enforce its claims when disputed.
- It constitutes a major legal and operational risk.

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Purpose of Confirmations

- Banking laws require credit institutions to confirm trades without delay and chase counterparties, if they do not approve the confirmation immediately.

  German Minimum Requirements for Risk Management (MaRisk), BTO 2.2.2 No.2:
  "*All trades must be confirmed without delay either in writing or in equivalent form. The confirmation must contain all required transaction data. [ ] The immediate receipt of counter-confirmations must be monitored [ ].*"

  Explanatory Memorandum to the German MaRisk:
  "*If, in respect to complex transactions, the parties agree that the confirmation is prepared by only one party, an ad-hoc confirmation (short form) exchanged immediately after the entering into the trade and a regular confirmation (long form) after the transactions data have been clarified is sufficient.*"

- The term "without delay" is to be construed with consideration of the complexity of the transaction, means of communication or other circumstances that could cause delay.
- Electronic messages systems or e-mails are only eligible for confirming trades if recognised as means of evidence by the relevant jurisdiction.

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Enhancing Confirmation Processes

- In order to speed up confirmation processes credit institutions may
  - use standardised confirmation templates or master confirmations
  - hire more employees
  - outsource confirmation processes
  - use trading platforms, central counterparties (*LCH Clearnet*) and confirmation matching systems (*SwapsWire, DTCC Deriv/SERV, SWIFTNet Accord, EFETnet, eConfirm*)
  - use straight through processes (*STP*)

Enhancing Confirmation Processes

- Modern banking laws encourage credit institutions to use clearing systems or confirmation matching system or STP processes.

German MaRisk, BTO 2.2.2 No.3:
"*No confirmation process is required for trades that are executed through a settlement system, which ensures an automated reconciliation of the relevant transaction data ("matching") and which executes trades only if the transaction data match.*"

Explanatory Memorandum to the German MaRisk:
"*The checks provided for in [BTO 2.2.2 No. 4 a) and b) in respect to completeness of business documentation and trader's tickets] are not required if the relevant transaction data entered into the trading system are automatically processed through to the back office.*"

- However, there will always be new products with new sophisticated structures for which no standardisation, automated confirmation matching or STP is available and which need manual handling by experienced personnel.

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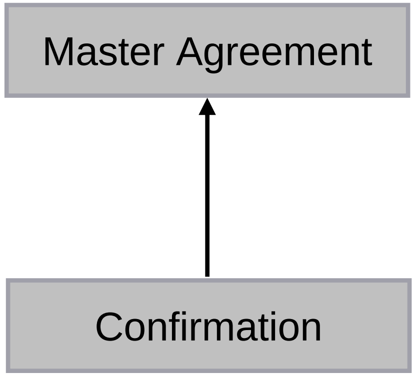
Confirmation and Close-out Netting

- The use of master agreements that provide for the termination and close-out of transactions in the event of a counterparty's default constitute an essential part of prudent credit risk management.
- A second purpose of Confirmations is to also provide evidence of the inclusion of a transaction into a master agreement.
- Legal uncertainty in respect of whether transactions are covered by master agreements jeopardises the credit institutions ability to close-out and net transactions upon default.
- Banking laws therefore provide that credit institutions must have sufficient evidence in order to prove that the transaction are included in the netting agreement.

German Large Exposure Regulation (GroMiKV), § 5(1) No.3:
"An institution may account swaps and other forward contracts or option rights at a reduced weighting […] if it […] has the required evidence by which it may prove, in the event of a dispute, that the transactions are included in the netting agreement."

Confirmation and Close-out Netting

- Two approaches can be distinguished:
- Bottom-up Approach: the confirmation refers to the master agreement



“This Confirmation supplements, forms part of and is subject to the ISDA Master Agreement dated as of 23 April 2007 [ ] between ABC Bank ("Party A") and XYZ Bank ("Party B").“

- Pro & Cons: It is the safest way to include transactions in a master agreement.
- However, it does not work if the systems used for the generation of confirmation do not provide for sufficient free text fields or if the confirmation matching system of a third party is used.

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Confirmation and Close-out Netting

- Top-down Approach: the master agreement specifies that it governs all transactions irrespective of whether they refer to it or not.

Master Agreement

Confirmation

"The Master Agreement shall apply to each Derivative Transaction entered into between the parties, irrespective of whether the terms of the Confirmation make reference to the Master Agreement ."

- Pro & Cons: It is the safest way if the Bottom-up Approach does not work. It's the preferred approach for repurchase transactions, stock loans, foreign exchange and bullion transactions.
- However, it requires a proper and unambiguous definition of the transactions so covered. Problems occur if more than one master agreement exist for the same product.

Confirmation and Close-out Netting

- Confirmation matching systems usually either or
  - rely on the Top-down Approach taken by the parties, or
  - they provide for own solutions e.g., by indicating that the transaction is deemed to be governed by the master agreement in place between the two parties, if any ("Deemed Bottom-up Approach").

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Unauthorised Transfers

- The issue of unauthorised transfers is closely related to Close-out Netting.
- In order to protect the single agreement concept, master agreements usually provide that the transfer of transactions is only permitted with prior written approval of the counterparty.

  ISDA 2002 Master Agreement, Section 7:
  "… *neither this Agreement nor any interest or obligation in or under this Agreement may be transferred [ ] by either party <u>without the prior written consent</u> of the other party …*"

- Transferring transactions without prior approval is void.
- Unauthorised transfers result in misrepresentation of credit risk and market risk.
- The 2005 ISDA Novation Protocol has addressed this issue.
- However, there is still room for enhancing (e.g., by greater use of automation of the notifications required under the protocol).

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