

Proactive Portfolio Reconciliation Can Transform OTC Derivatives Margining

By Susan Hinko

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The Collateral Framework Group, an adhoc group of industry professionals, recognized the opportunity and need to automate portfolio reconciliation for risk management purposes long before this function was branded as problematic. TriOptima, an original participant in this industry group, explains the history behind this group and how its initiatives reduce risk market-wide even during these tumultuous market conditions.

Beginning in 2006, before any hint of the crisis to come, there was a movement among collateral practitioners to transform the collateral management process for OTC derivatives. A group of OTC derivative dealers formed their own Collateral Framework Group (CFG) to address some of the most challenging issues facing their collateral operations including: increasing trade volume and diversity of portfolios; increasing numbers of collateral disputes; too many differences between portfolios and mark-to-market values; growing regulatory requirements to validate the accuracy of the portfolios; a frequent failure to complete reconciliations; and a general lack of analysis as to the root causes of the differences in portfolios between counterparties.

The importance of portfolio reconciliation had already been affirmed in ISDA's 2005 Collateral Guidelines developed by the ISDA Collateral Committee. The Guidelines state that "if the portfolio has not been reconciled and agreed, any collateral that flows back and forth between the parties is based on what may be an estimate of true exposure." Data standardization, automation, and regular trade-by-trade reconciliation were cited as important factors in reducing operational and credit risk as well as improving customer service.

Identifying the Challenge

The CFG members recognized that one of the keys to facilitating the margin process was to transform portfolio reconciliation from a reactive into a proactive activity. In the reactive mode, collateral managers would wait for a collateral call dispute and then request a reconciliation with the counterparty to identify why their collateral calculations were not in agreement. Spreadsheets were exchanged in most cases, and each side would manually begin to reconcile the portfolios. With some bilateral relationships reaching almost 100,000 trades across all the OTC derivative product lines, this was a challenging task. Frequently it wasn't completed before the market had moved and the collateral call changed direction. In these situations, reconciliations were frequently left incomplete.

Portfolio reconciliation begins with a basic comparison of the transactions each counterparty believes it has with the other. Before differences in the mark-to-market values of the transactions can be considered, any differences in the population characteristics must be resolved. These can be as simple a numerical booking error by an operations person, or a trader booking the counterparty to the wrong legal entity, or one firm booking the total amount of the trade and another splitting the amount among four desks or funds. For more structured trades, one institution may book the transaction as a single trade while the counterparty books it in three legs.

While these are not esoteric differences, it can be challenging to identify them when you are working with a spreadsheet of 40,000 entries that also uses different column headings and definitional terminology. But without agreeing the population of trades and their characteristics, counterparties can not go on to discuss differences in the mark-to-market values and the subsequent collateral obligation.

A Crisis-Tested Solution

In 2006, the CFG understood the urgency of transforming this process and, after evaluating several alternatives, the five firms comprising the CFG decided to work with TriOptima's new portfolio reconciliation service triResolve to start proactively reconciling their portfolios with each other. TriOptima had developed triResolve out of its highly refined matching technology that also drives its triReduce multilateral termination service.

As the CFG members began to reconcile their portfolios regularly, they saw the level of automatching increased from 87% in the beginning to over 98% after several reconciliations. Once the population differences had been researched and resolved, the trades remained matched from one reconciliation to the next and only incremental trades or those still unresolved showed up as unmatched. This enabled the dealers to focus on the mark-to-market exposures with their counterparties and to resolve their collateral disputes more quickly.

In the spring of 2008, when the Bear Stearns crisis evolved, dealers who had been reconciling regularly and proactively, understood their exposures to Bear Stearns and to each other. Later in the fall, leading up to the Lehman failure, collateral departments were able to move easily to daily reconciliation on triResolve and produce reports for their senior managements that identified the largest counterparty credit exposures by counterparty and by product type throughout the crisis.

Setting New Standards

The initiative shown by the CFG meant that the ISDA Collateral Committee could write in the Operations Management Group's (OMG) October 31, 2008 letter to the New York Fed regarding collateral management, "Investment by market participants...has significantly increased risk capacity in the derivative market and during recent credit market events has materially reduced losses that otherwise would have been suffered by firms." The careful collaboration with TriOptima on refining a service that empowered them to reduce risk and manage credit crises has given them the tools they need to meet the challenges of the banking supervisors.

A range of measures has been identified for improving the collateral management process even further. They relate to both the portfolio reconciliation process but also the full range of collateral management activities including dispute resolution, practices for dealing with reference credit events, changes to the ISDA Credit Support Annexes, electronic communication of margin calls and the tightening of the margin call, settlement and cure periods.

However, the basic foundation of collateral management is timely, accurate portfolio reconciliation; and the major dealers have driven the market to new standards beginning with the ISDA Collateral Committee July 31, 2008 commitment to achieve weekly inter-dealer reconciliation of collateralized portfolios exceeding 5,000 trades by December 31st. They also committed "to provide adequate resources to identify and resolve portfolio differences on a timely basis, and ...create escalation procedures for resolution of material differences..."

The December 31 goals have been met and exceeded as of April 2009. In fact, the major dealers of the OMG have committed to reducing the threshold portfolio size for weekly reconciliations from 5,000 to 500 trades and moving the frequency of reconciliation from weekly to daily by June 30th. Many market participants have already achieved the daily reconciliation standard for all their inter-dealer portfolios.

The Way Forward

Currently all of the major dealers use triResolve for their reconciliations. Over 5 million trades (single-counted)

across all OTC derivative products are reconciled regularly through triResolve. This includes complex structured products; equity, commodity, interest rate swaps and options; fx forwards, credit derivatives and anything else that is collateralized between counterparties. Unlike existing and planned clearinghouses, there are no product constraints to reconciliation so that even the most challenging transaction types are monitored and margined.

The OMG dealers have also committed to collecting and reporting metrics regarding their portfolio reconciliation activities to the banking supervisors. They are able to provide regulators with information on the number of portfolio reconciliation cycles performed and planned, the average number of trades and the matching status of those trades. This information is easily produced by the triResolve service and provided the dealers on a regular basis.

These standards and targets currently only apply to the major dealers of the ISDA Collateral Committee and the OMG; however, there seems to be a recognition by other market participants on both the buy and sell side that there are good reasons to implement these standards beyond that group. Many buy-side participants found that they had trouble accessing their collateral during the Lehman Brothers failure. This led to the realization that they would benefit from tightening up the processes around their own collateral management programs. Over time, it appears that the market will generally adopt this proactive reconciliation practice which will contribute to even further risk reduction in the financial systems.

While the events of last year accelerated the adoption of the proactive reconciliation approach, it is heartening to note that virtually all of the ground had been covered by the ongoing activities of the ISDA Collateral Committee and the efforts of the Collateral Framework Group and that progress will continue within individual financial institutions, contributing to the risk management of the firms and to the overall stability of the market.

- "Proactive Portfolio Reconciliation" is part of the Spotlight series on the OMG Commitments. In each article consultants provides its expert insight and practical advice on how financial institutions should change internal processes to improve efficiency and comply with commitments outlined by the Operations Management Group.

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