

**ISSA**



**OTC Derivatives Working Group**

**5th June 2008**

ISSA OTC Derivatives Working Group

### Introduction

- The objectives of the International Securities Services Association's (ISSA) OTC Derivatives Working Group (the Working Group) at a high level include the following:
  - Debate key industry issues relating to OTC derivatives and achieve demonstrable progress in moving issues forward
  - Wherever possible, draw conclusions that can be used to influence the broader industry agenda
  - Publish the conclusions in the form of industry best practices that are supported by the ISSA membership
- The Working Group recommended a focus on three specific areas that are most fundamental to improving the processing and management of OTC derivatives:
  - Verification of Valuations - JP Morgan was assigned as lead sponsor
  - Trade Capture - Morgan Stanley was assigned as lead sponsor
  - Confirmations - Schroders was assigned as lead-sponsor
- Additionally, the Group recommended producing an OTC Derivatives Primer to provide context for the specific recommendations

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**Working Group Scorecard**

Project	Lead Sponsor	Status	Comments
Verification of Valuations	JP Morgan	On-track	Awaiting final approval from ISSA Board before publication
OTC Derivatives Primer	JP Morgan	Version 1.0 complete	This will continue to be a 'work in progress' - recommendation is to commence Version 2.0 based on ISSA feedback
Trade Capture	Morgan Stanley	In planning stages	Need to re-mobilise support for the project from the ISSA membership
Confirmations	Schroders	On-hold	Put on-hold subject to resolution of Trade Capture project support

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**Verification of Valuations - Working Group Update**

- Objective is to establish best practices which, by necessity meet the following criteria:
  - Should be in-line with current regulatory requirements
  - Should be scalable and controllable
  - Needs to reduce reliance on counterparty prices
  - Needs to consider convergence with cash instruments, e.g. daily verification
  - Should leverage existing processes wherever possible
  - Should not exclude reference to a fair market value proxy
- Emphasis on best-practice does not mean whatever is suggested is the only practice
- Other standards can and will exist that take into account different jurisdictional requirements, client typologies and practical considerations such as volumes or indeed the materiality of the risks mitigated by the control
- Published best practice should seek to detail the reasons why the options considered have been defined as being either best practice or otherwise

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### Participation

- First meeting in October 2007 with subsequent meetings in November and December 2007 included:
  - BNP Paribas
  - Deutsche Bank
  - JP Morgan
  - Morgan Stanley
  - Schroders
  - UBS
- Informal discussions with a number of Audit firms to validate recommendation
- High level review of key market vendors/utilities capabilities to support proposal
- Final recommendation presented to ISSA Board in December 2007
- Proposed publication sent to ISSA members for review in January 2008

### Summary of current regulatory frameworks for key markets

	UCITS	France	Ireland		Luxembourg	United Kingdom
Primary Valuation Source	Counterparty valuation on a daily basis	Counterparty valuation on a daily basis	Counterparty valuation on a daily basis	Independent valuation calculated by the Collective Investment Scheme or by a pricing vendor on a daily basis	Counterparty valuation on a daily basis	Counterparty valuation on a daily basis
Alternative Valuation Source	Independent valuation using pricing models	Independent valuation using pricing models			Independent valuation using pricing models	Independent valuation using pricing models
Verification Procedure	Validated against an appropriate and independent third party source or independent unit within the UCITS	Validated against an appropriate and independent third party source or independent unit within the UCITS	Verified by an independent party who is approved for the purpose by the trustee	Reconciled to the counterparty valuation	Validated against an appropriate and independent third party source or independent unit within the UCITS	Validated against an appropriate and independent third party source or independent unit within the UCITS
Verification Frequency	On an "adequate frequency"	On a "regular" basis	At least weekly	On a monthly basis	On an "appropriate frequency"	On an "adequate frequency"
Resolution Requirement	Not clearly defined	Not clearly defined, but industry practice is for the UCITS pricing committee for the fund to define the requirements	Not clearly defined	Significant differences must be promptly investigated and explained	Not clearly defined, but industry practice is for the UCITS pricing committee for the fund to define the requirements	Not clearly defined

Summary of verification of valuations options

	Option 1	Option 2	Option 3	Option 4	Option 5	Option 6
Primary Valuation Source	Third party independently calculated price	Third party independently calculated price	Third party independently calculated price	Price calculated by an independent unit of the Investment Manager	Price calculated by an independent unit of the Investment Manager	Price calculated by an independent unit of the Investment Manager
Verification of Valuation Source	Price calculated by an independent unit of the Investment Manager	Counterparty price	Price calculated by an independent unit of the Investment Manager	Third party independently calculated price	Counterparty price	Third party independently calculated price
Additional Verification of Valuation Source			Counterparty price			Counterparty price
Pros	More scalable as less reliance on counterparty prices Leverages existing operational processes	Fair market value proxy incorporated in process	More scalable as less reliance on counterparty prices Fair market value proxy incorporated in process	More scalable as less reliance on counterparty prices Leverages existing operational processes	Fair market value proxy incorporated in process	More scalable as less reliance on counterparty prices Fair market value proxy incorporated in process
Cons	Does not appear to comply with Irish regulations No fair market value proxy	Does not appear to comply with standard UCITS Does not resolve counterparty price collection issues	More costly as three valuation sources required	Does not appear to comply with Irish regulations No fair market value proxy Less demonstrable transparency for primary valuation	Does not appear to comply with standard UCITS Does not resolve counterparty price collection issues Less demonstrable transparency for primary valuation	Potentially more costly as three valuation sources required Less demonstrable transparency for primary valuation

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Verification of valuations ‘best practice’ recommendations

- Based on a detailed review only options 3 and 6 satisfy all six criteria
- The ‘best practice’ recommendation is therefore:
  - Primary Valuation: should be either a third party independently calculated price or a price calculated by an independent unit of the Investment Manager
  - Verification of Valuation: should be performed on a weekly basis by comparing the primary valuation versus either a third party independently calculated price or the price calculated by an independent unit of the Investment Manager (depending on which one is used for the primary valuation)
  - Additional Verification of Valuation: should be performed on a monthly basis using the counterparty price versus the primary valuation

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### ISSA membership feedback received to date and next steps

- ISSA membership feedback on the publication has been received from:
  - BBH
  - BNP Paribas Securities Services
  - Citibank
  - Deutsche Bank
  - HSBC
  - Schroders
  - UBS
- Next steps:
  - Publish Verification of Valuations recommendation
  - Collate feedback on Version 1.0 of the OTC Derivatives Primer
  - Review current sponsorship and support for two remaining projects

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### Appendices

- Appendix 1
  - UCITS guidelines, March 2007
- Appendix 2
  - CESR Guidelines, March 2007

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### Commission Directive 2007/16/EC - 19<sup>th</sup> March 2007

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- The reference to reliable and verifiable valuation shall be understood as a reference to a valuation, by the UCITS, corresponding to the fair value..., which does not rely only on market quotations by the counterparty and which fulfils the following criteria:
- The basis for the valuation is either a reliable up-to-date market value of the instrument or, if such a value is not available, a pricing model using an adequate recognised methodology;
- Verification of the valuation is carried out by one of the following:
  - An appropriate third-party which is independent from the counterparty of the OTC derivative, at an adequate frequency and in such a way that the UCITS is able to check it;
  - A unit within the UCITS which is independent from the department in charge of managing the assets and which is adequately equipped for such purpose

### CESR guidelines, March 2007

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- The “process for accurate and independent assessment of the value of the OTC derivatives” requires:
  - “a process which enables the UCITS throughout the life of the derivative to value the investment concerned with reasonable accuracy at its fair value on a reliable basis reflecting an up-to-date market value”
  - “a risk analysis realized by a department independent from commercial or operational units and from the counterparty or, if these conditions cannot be fulfilled, by an independent third-party
    - ... in the latter case, the UCITS remains responsible for the correct valuation of the OTC derivatives and must, inter alia, check that the independent third-party can adequately value the types of OTC derivatives it wishes to conclude”
- CESR’s view is that “independent” and “adequately equipped” in this context means a unit which has the adequate means (both human and technical) to perform this valuation. This implies that the UCITS has its own valuation systems, which can however be provided by an independent third party. This excludes the use of valuation models provided by a party related to the UCITS (such as a dealing room with which OTC derivatives are concluded...)

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