

SECTION IV: FINANCIAL INFRASTRUCTURE — DOCUMENTATION AND RELATED POLICIES AND PRACTICES

In this section, the Policy Group provides a review of the recommendations made in Section III of the 1999 CRMPG I report, and includes updates and new Recommendations and Guiding Principles as necessary. Section III of the 1999 report, entitled “Improving Market Practices and Conventions,” focused on three broad areas: improvements in documentation policies and practices, with a special emphasis on timelines; improvements in documentation content, with special attention to close-out and valuation issues and the basis risk arising from inconsistencies in standard forms of industry documentation; and improvements in collateral management practices. The recommendations shared two common goals: to improve a creditor’s ability to deal with failing counterparties in a timely manner, and to enhance the market’s ability to contain the risks of failures of large, leveraged participants.

The 1999 report led to the establishment of the Global Documentation Steering Committee, whose mission is to implement the documentation-related recommendations contained in Section III. In particular, the GDSC’s objective is to carry out the CRMPG’s 1999 mandate by minimizing “documentation basis risk” — the risk that market, credit and legal risk will be exacerbated by disparities in documentation — in the over-the-counter markets.

Much progress has been made since 1999, but much remains to be done.

First, a suite of robust, contractual tools to reduce documentation basis risk has been developed. These tools include recommendations made by the GDSC as part of its documentation harmonization efforts, the development of the Bond Market Association’s Cross-product Master Agreements and the publication of the 2002 ISDA Master Agreement and the 2001 ISDA Bridge Agreement. Although these contractual tools were developed with broad participation of various market segments, their utilization has so far been limited. Thus, their effectiveness may be dulled by lack of usage.

Second, rules governing the calculation of regulatory capital as well as accounting principles have a significant impact on the financial markets, and should be crafted to encourage the use of risk-mitigating tools such as cross-product and cross-affiliate netting agreements. These include the rules of the Basel Committee on Banking

Supervision and related national supervisory rules relating to the calculation of regulatory capital, US margin rules relating to regulated broker-dealers and US and international accounting practices.

Third, the integration of trading, reporting and control functions, known as “straight through processing,” promises a multitude of systemic benefits for the financial sector. These benefits include the reduction of counterparty risk through transaction affirmation, confirmation matching, more timely and accurate risk assessment of trading information, greater control of the trading process itself, enhanced collateralization techniques and a potential decrease in regulatory capital charges as these improvements demonstrate their risk reduction capabilities. The emergence of electronic trading and confirmation matching and generation platforms, ISDA’s development of FpML (an electronic information transfer protocol for the over-the-counter derivatives market) and the availability of services such as those offered by the Fixed Income Clearing Corporation for the repo market present a compelling opportunity to move the industry closer to straight through processing. These technological innovations, coupled with set-off rights across affiliates of a non-defaulting party and expanded acceptance of netting for regulatory capital purposes, would have a potentially significant impact on the industry. In sum, straight through processing would provide major advantages in each risk category addressed in this paper. Accordingly, implementation of straight through processing must be an industry priority going forward.

At the Policy Group’s request and on its behalf, the GDSC has taken the lead in compiling this update and providing any new or revised Recommendations or Guiding Principles. Set forth below is the Policy Group’s discussion of post-1999 developments and its recommendations for future market practices. Discussion of credit derivatives, which have gained in significance since 1999, has been added as a separate section. As a general matter, to the extent that standard industry documentation is updated to facilitate market efficiency and reduce documentation basis risk, market participants are encouraged to adopt such new standards in existing as well as prospective agreements with counterparties.

A. Documentation Policies and Practices

1999 Recommendation #13

FI's should have in place written policies to manage documentation risk. Such policies should be approved by senior management and reflect the nature and scope of their business and risk profile. Such policies should address the following factors:

- *Creation and execution of documents pertaining to privately negotiated OTC transactions, including master agreements and confirmations;*
- *Sensitivity to documentation risk factors, such as counterparty credit quality, jurisdiction and transaction complexity;*
- *Procedures for identification of principals acting through agents;*
- *Timelines for completion of master agreements and confirmations;*
- *Procedures for granting exemptions and exceptions; and*
- *Procedures for tracking backlogs and violations.*

Update

To the extent that trading occurs in advance of master agreement execution, market participants have established formal or informal policies to address such trading. These policies and procedures are typically administered by the legal, documentation, compliance or credit functions or a combination thereof. Market participants have similarly developed systems to track violations of any applicable documentation policies and backlogs of unsigned trade confirmations and other documents. The role of investment managers who trade on behalf of principals has grown significantly, and the monitoring of such arrangements has accordingly become more refined. Tools which are used in assessing counterparty and jurisdictional risk include internal data bases and products such as Netalytics and CSAnalytics, which respectively summarize ISDA's netting and collateral opinions. The importance of good documentation and robust documentation procedures is generally recognized by senior management as an effective risk mitigant and a key component of the internal oversight and control function. Since 1999, the ongoing development of internal documentation tracking and scanning systems has greatly facilitated the monitoring of documentation status and the attendant risks.

1999 recommendation affirmed, with increased emphasis on risk-based assessment of documentation risk rather than strict timelines.
--

1. Timeframes and Monitoring

1999 Recommendation #14a

FI's should adopt a goal to execute new master agreements within 90 days of a transaction and, pending such execution, utilize a "long form" confirmation that incorporates the industry standard form of master agreement.

Update

Significant market participants have developed methods to monitor unsigned documentation and to assess the time frames required for completing master agreements, and prioritize their negotiations accordingly. To the extent that master agreements are not signed when a trade is done, trade confirmations which incorporate a form of master agreement are commonly used. In addition, in October 2004, a conference on "How to Improve Master Agreement and Related Trading Agreement Negotiations" was held at the Federal Reserve Bank of New York, which led to publication by the Global Documentation Steering Committee of *A Practitioner's Best Practice Guide*. This Best Practice Guide is intended to serve as a model for evaluating and developing master agreement negotiation procedures. These policies and initiatives are critical in view of the lengthy time frames required to finalize some master agreements.

10. Guiding Principle, Category I

Market participants should look to the GDSC publication, *How to Improve Master Agreement and Related Trading Agreement Negotiations — A Practitioner's Best Practice Guide*, for guidance in negotiating master agreements. The Best Practice Guide suggests certain time frames for completing the negotiation of master agreements, and market participants should also prioritize the negotiation of unsigned master agreements by assessing portfolio exposure; evaluating unsigned master agreements in combination with unsigned confirmations; looking to collateral, counterparty type and counterparty jurisdiction in assigning risk to unsigned master agreements and confirmations; and identifying which ongoing negotiations are with prospective versus live counterparties.

11. Recommendation, Category I

CRMPG II recommends that market participants also ensure that credit, legal and documentation departments and the relevant businesses have access to master agreements themselves and an understanding of their content, and should consider developing a process to identify agreements in need of updating.

B. Operational Efficiency and Integrity

1999 Recommendation #14b

FI's should send out confirmations for privately negotiated OTC transactions by the business day following the trade date and, within five business days thereafter, assure themselves that there is agreement with their counterparty on the material terms of the trade and that they have written evidence of their binding agreement. There should also be agreement at the outset of a relationship on which party will initiate the confirmation.

Update

Confirmations are sent out as soon as possible after the trade date, and market convention as well as bilateral agreements between market participants typically establish which party will send a confirmation. While “plain vanilla” transactions are increasingly confirmed swiftly via electronic trade matching systems such as DTCC and SwapsWire and confirmation generating services such as Thunderhead, more structured transactions require significant drafting and internal review. Experience has shown that this process typically takes more than one day. As a general matter, the ISDA Operations Benchmarking Survey, available at www.isda.org, is a helpful resource in this area.

In the recent past, derivatives trading volume has grown dramatically, especially for credit derivatives. This greatly increased volume, together with internal resource limitations, prevents many confirmations from being processed, reviewed and signed promptly after the trade date, and has led to a significant industry-wide backlog of unsigned confirmations.

12. Recommendation, Category I & II

Market participants recognize the immediate need to address the backlog of unsigned confirmations on an industry-wide basis and are currently committing substantial resources to its resolution. CRMPG II recommends that, as a matter of urgency, market participants apply additional resources to this task, take part in and strongly encourage the development of electronic trade matching and confirmation generation systems and work together as well as cooperatively with trade associations to identify and implement solutions. In addition, market participants should make use of one or more of the following: using master confirmations, circulating drafts of structured confirmations pre-trade, pre-negotiating short form confirmations pre-trade, signing or initialing term sheets pre-trade and orally verifying material trade terms promptly after trade date. Moreover, individual institutions should periodically inform senior management and their primary regulator about progress being made in reducing confirmation backlogs. In extreme cases, senior management should be prepared to consider whether trading volumes need to be reduced until the backlog is normalized. CRMPG II endorses the convening of an industry-wide roundtable in the near term to focus on aggressively reducing confirmation backlogs by working toward further technological and operational enhancements, and by strengthening back-office operations.

1999 Recommendation #14c

FI's should track unexecuted masters, unsent confirmations and unaffirmed trades, develop a risk-based approach to clearing backlogs and report to senior management material deviations from internal documentation policy. Furthermore, they should develop incentives for business units and clients to correct material deficiencies in their documentation practices, which might include trading restrictions, mandatory unwinds and reserves for losses.

Update

Market participants have generally developed systems or methods to track master agreements and confirmations via a risk-based approach. As part of an internal control framework, they also typically involve senior management when material documentation deficiencies arise. Many market participants also take part in industry efforts to improve and streamline operational practices, such as ISDA's initiatives in this area. Regulatory capital guidelines which recognize the benefits of executed master agreements by providing more favorable netting and collateral treatment also provide quantitative and qualitative incentives for document execution.

13. Guiding Principle, Category I & II

In addition to the pressing tasks outlined in Recommendation 12, market participants should also engage in industry initiatives to identify and develop effective methods of monitoring and addressing backlogs and compliance with policies, use internal audit or other independent mechanisms to identify shortcomings and measure progress and foster vigorous governance and management controls.

1999 Recommendation #15

Industry participants should support efforts to introduce greater automation in the documentation process for privately negotiated OTC contracts. The Policy Group also encourages service providers to consider new opportunities that may exist in these markets, and it encourages regulators to work in cooperation with industry participants and service providers to facilitate these efforts and refrain from erecting regulatory barriers that may impede service innovations.

Update

Since 1999, the industry has placed great emphasis on automated trade processing and matching with the goal of reducing the risk of trade discrepancies as well as backlogs of unconfirmed trades, and major strides have been made. Today, at least four major service providers are focused on auto-matching of OTC derivative transactions. In alphabetical order, they are:

(a) Depository Trust Clearing Corp. (DTCC)

DTCC's DerivServ product is currently used to match default swap transactions. As of this writing, DerivServ's membership numbers one hundred as of June 30, 2005, and includes some twenty investment and commercial banks and eighty buy-side firms. Approximately a third of DerivServ members' credit derivative volume is confirmed in DTCC. Both membership numbers and the percentage of trades confirmed through DTCC are expected to increase as more participants, particularly hedge funds, join DTCC. It is also anticipated that assignments, which comprise a large part of the default swap market, may be confirmed through DerivServ in the future, and that DTCC may expand to other products such as equity derivatives. The inclusion of assignments within the scope of DerivServ would significantly increase the percentage of DTCC member firms' credit default swaps confirmed via DTCC, perhaps reaching 60 – 70% of all DTCC member trades.

(b) eConfirm

The IntercontinentalExchange provides an internet-based back-office system for efficient matching of trades and execution of confirmations in select commodities markets through their "eConfirm" product. Participants are offered documentation to modify existing master agreements to recognize

eConfirm electronic confirmations. The eConfirm system accepts inputs of extracted trade data from participants' systems (using an XML application programming interface or other means) and uses this data to match trades with those of other participants. Matched trades then become executed confirmations. Through this process, eConfirm provides participants with the matched status of their trades and tracking information to facilitate the resolution of unmatched trades. IntercontinentalExchange states that eConfirm provides its customers with real-time results and match rates of up to 95% of the trades submitted to its system within a short period of time (typically, a few minutes to a few hours). eConfirm's matching system functions in North America, Asia and Europe for a variety of commodities markets, including physical and financial natural gas and physical and financial power, and a "variety" of trade types. eConfirm participants include investment banks, utilities, energy marketers and hedge funds.

(c) SwapClear — LCH.Clearnet (LCH)

SwapClear is a central counterparty and clearing-house service for OTC interest rate derivative transactions. SwapClear's membership is comprised of nineteen banks. In SwapClear, LCH.Clearnet acts as the "counterparty" to both sides of an interest rate derivative transaction. At trade execution, two SwapClear members submit an eligible trade for clearing, and on acceptance, the trade is novated so that each member faces LCH Clearnet for the life of the trade. Historical trades can also be back loaded into the facility.

(d) SwapsWire

SwapsWire provides electronic trade confirmation, electronic broker confirmation, and trade capture primarily for interest rate derivatives. A trade processed through SwapsWire is thus executed, accepted and confirmed through the facility. Once a trade is affirmed by a trader in SwapsWire, acceptance is instantaneous and internal documentation specialists are not involved in the trade confirmation process. SwapsWire has electronically confirmed over 330,000 transactions, with an annualized "run rate" of 400,000. 99% of transactions are confirmed on trade date. SwapsWire's membership includes over twenty five banks as well as fifteen brokers and "buy side" firms.

DTCC, eConfirm, SwapClear and SwapsWire are only a few examples of the multiple service providers focused on auto-matching of OTC derivative transactions.

Regulators, among them the CFTC and the SEC, have taken a number of formal and informal steps to clarify the status of and encourage certain electronic trade assistance services. The Commodity Futures Modernization Act of 2000 was a positive development on the legislative front.

Please note: the above descriptions of service providers and services are based on publicly available information or information available from the service providers themselves.

14. Guiding Principle, Category I & II

Electronic trade assistance services promote efficiency and confidence in the markets, and both market participants and trade associations should strongly encourage automation in the processing of OTC transactions. Automation, including electronic trade affirmation and matching and straight through processing, is a key risk mitigation device, at least in part because most risk metrics assume the existence of an underlying, undisputed transaction. Automation must be pursued whether or not it presents any short-term economic benefit.

Realized and potential benefits of electronic trade processing and matching include:

- Paperless environment, highly efficient and much more accurate;
- Greatly reduced counterparty risk stemming from unsigned trade confirmations and trade disputes;
- Faster and more accurate risk management access to trading processes and information;
- Efficient and accurate margining;
- Tremendous scale, allowing growth in volume without adding manual process;
- Reduced fund transfer costs and error ratio; and
- Potential reduction in regulatory capital costs as regulators recognize the risk reduction benefits of these initiatives.

Discussion — Straight Through Processing

Confirmation matching, discussed above, and payment netting, discussed under Guiding Principle 16b, are two important aspects of trade processing in a number of markets. As noted above and below, there are substantial gains in electronic automation taking place with respect to both of these aspects. The ultimate promise of electronic automation, however, is “straight through processing” (STP), a term used to describe the much-anticipated integration of the trading, reporting and control function of trading businesses through electronic media. Ideally, STP would begin with a trade accomplished electronically and continue by electronic transmission and manipulation of trade data through confirmation messaging, middle-office functions and finally back-office systems reporting; record keeping; payment netting; and settlements. Ultimately, straight through processing should surround the trading process itself with inputs yielding better informed and controlled trades. The promise of STP is greater speed and accuracy of the above processes, increased netting capabilities, the elimination of operational redundancies and, most importantly, through the combination of such benefits a reduction in financial market risk.

To realize the potential of STP, a variety of technical systems such as electronic trading platforms, automated confirmation and trade matching systems, middle and back office reporting, record keeping and payment netting functions must all be seamlessly integrated internally. In addition, even if counterparties enjoy seamless internal processing, they must be able to communicate easily with one another at very low rates of error.

The challenges in achieving STP vary from market to market. As is illustrated in the examples below, it is perhaps easier (though by no means easy) to develop STP in relatively centralized markets involving relatively standardized financial products. Even in such markets, however, along with technological issues, STP presents an array of concerns about transparency, access, competition, confidentiality, enforceability and governmental oversight, among others. These concerns, variable in nature from market to market, must be addressed if we are to realize the systemic benefits of STP.

(a) Privately Negotiated Derivatives

As illustrated above, the over-the-counter derivatives markets have focused on developing electronic automation of affirmation and confirmation matching

processes as well as payment netting, discussed under Guiding Principle 16b. More generally, the International Swaps and Derivatives Association has undertaken a number of projects intended to promote awareness of the need for and development of the automated processes that may be linked into STP. ISDA gathers data on these processes annually.

ISDA's development of FpML, an XML based electronic information transfer protocol specific to over-the-counter derivatives, is an enormous contribution to the development of STP in the over-the-counter derivatives markets. The hallmark of these markets has been product customization and diversity. FpML provides a necessary uniform basis for electronic data transmission in this diverse transactional environment.

(b) Futures Trading

Understanding that differences may exist in the degree of automation of futures trading on various exchanges, the status of STP on the Chicago Mercantile Exchange (CME), a highly prominent exchange that has actively developed its electronic capabilities, is used here as a case study.

On the CME, trading can be accomplished electronically or through traditional means. Even in the case of traditional means, the open outcry methodology of the pits is electronically supported in a number of respects. Generally speaking, all interactions of a clearing firm with the clearing house are electronically automated. It is possible, as a result, for the other entities in the life cycle of a trade to join in the creation and distribution of electronic information and manage their participation in the trading process electronically.

Customers can electronically access either their Futures Commission Merchants (FCM) or the CME directly (in which case the FCM is electronically notified) in order to initiate a trade. Responses from the clearing house to the clearing member will indicate that trades are filled (e.g., committed, subject to a period when a break process may intervene) and separate messages will be sent to back offices. Customers, who may use "front end" systems provided by independent vendors, may be apprised of their trades' status through these front end systems. Controls may be imposed at each step of the process so that, for instance, customer identity, trading limits and margin requirements are verified. Similarly, appropriately equipped back and middle

offices can examine and process the electronically available trade information. The CME clearing system is now processing more than two million trades a day, including trades emanating from the Chicago Board of Trade.

FIXML, an XML implementation of the FIX open message standard, is used for exchanging electronic trade information and is a valuable new tool for sending trade-related messages. It can assist market participants in achieving straight through processing and is also important to the success of the CME system. FIXML allows for real-time communication between the clearing house and clearing members to accomplish post-execution processing. Other such protocols and implementations are available and in use in other contexts. To connect to the CME system and generate and receive compatibly organized messages, any front end system must use “iLink,” the CME's implementation of the FIX protocol.

The degree of flexibility afforded by the CME's electronic automation is illustrated by the “CME FX on Reuters” project. This project enables users of the Reuters Dealing 3000 spot foreign exchange electronic trading platform to electronically access CME foreign exchange futures presented in “spot-equivalent” terms.

It is important to consider, when comparing the degree of electronic processing available through the CME to that in the OTC derivatives markets, that (i) the financial instruments available through the CME are relatively standardized and (ii) the position of the CME clearing function as the central counterparty in the market gives the CME the standing to make systems choices and then enforce those choices.

(c) Repos

Over the last ten years, the US repo market has experienced consistent substantial growth. Nonetheless, the market is very liquid and a significant portion of traded contracts are relatively standardized and undifferentiated. In addition, the interdealer market is supported by a central clearing facility, the Fixed Income Clearing Corporation (FICC). All of these factors make this an attractive market for electronic trading.

The US repo market is served by just a few electronic trading platforms. The following is a summary of several of these platforms and some of their products:

- *BrokerTec*: Repos on overnight and term Treasury general collateral, agency general securities, all general securities finance repo products, Treasury specials, agency benchmark specials, TIPS and STRIPS.
- *Morgan Stanley Repo Link*: Repos on Treasuries, agencies, GNMA and MBS pools, corporates, money markets and whole loans.
- *LehmanLive*: Repos on overnight and term general securities, general securities finance repo products, specials, agencies, mortgages, corporates, emerging market debt and whole loans.

To accommodate the tremendous volume growth in the repo markets, numerous enhancements have been made to foster straight through processing. These enhancements have focused on trade execution, trade entry and settlements. For instance, in the interdealer market, FICC has a real-time trade matching engine that accepts trades from participants that could have been transacted via an electronic platform or via voice execution. When coupled with the fact that FICC also acts as a central counterparty, this allows for trades to compare gross (per counterparty) but settle on a net novated basis per CUSIP number. FICC has also developed and brought to market a product called General Collateral Financing (GCF), which allows market participants to trade a securities class rather than a specific issue. This is accomplished by trading generic CUSIPs which represent the principal value of the repo transaction, and which are collateralized by existing securities on an automated basis and settled outside of the normal delivery versus payment (DVP) cycle on the Fed Book Entry Settlement System. Since many participants in the funding markets are not eligible to become members of FICC nor does FICC presently support all securities, the tri-party repo method has been developed to alleviate some of the burden of DVP transactions. A tri-party transaction is one in which two counterparties agree to a purchase or sale of acceptable securities agreed to in the financing documentation. The transaction is facilitated at a clearing bank which acts as an agent for both parties to ensure simultaneous processing of cash and

securities, as well as of maintenance events such as rate resets and re-pricing. The growth of these two mediums, FICC and tri-party repo, has added enormous capacity to the market. Many market participants trade over 70% of their generic financing needs via these methods.

The next phase of STP for the repo markets is taking place in the trade maintenance sector. This maintenance can take many forms, such as re-rating in the case of variable rate trades, re-pricing to alleviate market exposure, rolling over or terminating in order to meet new daily funding requirements and netting of deliveries and receipts to reduce security and cash processing. FICC, as well as many dealers and some vendors, are in the midst of developing web-based interactive tools to accomplish much of this. Whether participants develop their own methods for addressing these issues or purchase a vendor package will depend on the technological expertise, economies of scale and customized relationships that exist between client and dealer. In either case, many options are available.

15. Recommendation, Category I & II

CRMPG II recommends that trade associations and market participants must pursue and develop straight through processing of OTC transactions, a critical risk mitigant in today's high volume markets. As a fundamental matter, disputes over the existence or the terms of a transaction have the potential for enormously increasing risk, since each party to the disputed transaction hedges and risk manages the disputed trade based on certain economic assumptions. STP reduces the number and frequency of trade disputes and maximizes market efficiency, opportunity and access. STP therefore fosters legal, credit, market and operational certainty.

C. Netting, Close-Out and Related Issues

1999 Recommendation #16a

Close-out and Valuation: Documentation should be revised as necessary to ensure that a non-defaulting party has the flexibility to value transactions in a good faith and commercially reasonable manner. This should be a common industry standard, as incorporated in the TBMA/GMRA, and FEOMA agreements and ISDA's Loss methodology.

1999 Recommendation #16b

To the extent that market quotations are employed to achieve commercially reasonable valuations, ISDA agreements should be modified to provide that:

- *Potential quotes provided by third parties may include not only price, but also yields, yield curves, volatilities, spreads or other relevant inputs. These inputs should be based on the size of the transaction, the liquidity of the market and other relevant factors.*
- *The number of third parties from whom inputs are sought may be reduced.*
- *Third parties from whom inputs may be sought may include not only dealers, but also major end-users, third party pricing sources or other relevant sources.*
- *Market quotations are but one means to achieve good faith valuations and may be by-passed when, in the judgment of the non-defaulting party, they are unlikely to produce a timely and commercially reasonable result.*

As noted in the 1999 report, the MRA, GMRA, FEOMA and similar master netting agreements provide for a significant degree of flexibility in close-out valuations. Similarly, the 2004 International FX and Currency Option Master Agreement (the IFXCO Master Agreement), published by the Foreign Exchange Committee, adopts a flexible close-out approach. ISDA's "two-pronged" approach to close out valuation was amended in the 2002 ISDA Master Agreement, when the election between Market Quotation and Loss was replaced with a single provision, Close-out Amount.

Close-out Amount was designed to offer greater flexibility to the party making the determination of the amount due upon the occurrence and designation of an Early Termination Date, and to address some of the potential weaknesses of Market Quotation that became apparent during periods of market stress in the late 1990s.

Close-out Amount was the product of extensive discussions between banks, hedge funds and other market participants, and it accomplishes the goals set forth in the

1999 Recommendation. The Policy Group also appreciates that the process followed in producing Close-out Amount was motivated by a desire to strike the balance that the Policy Group believes is appropriate for an effective close-out methodology. Nonetheless, some Policy Group members and a number of market participants continue to favor the Loss or Market Quotation methodologies set forth in the 1992 Master Agreement. The reluctance of some market participants to adopt the Close-out Amount definition appears to result from concerns regarding provisions in the definition specifying the circumstances in which valuations need not be based directly on market quotations for replacement transactions or on other third party market data and from related concerns that the discretion afforded the Determining Party under that definition, even though circumscribed by standards of good faith and commercial reasonableness, could produce a close-out amount that is unduly favorable to the Determining Party.

The Policy Group recognizes that each of the three ISDA methodologies has certain strengths and weaknesses that depend on, among other factors, the characteristics of the underlying product and prevailing market conditions. The Policy Group is concerned, however, by the significant potential uncertainty associated with liquidation values that could arise either in connection with the close-out of less liquid products or in connection with the close-out of otherwise liquid products in a period of significant market stress and illiquidity, where contracting parties have not adopted the Close-out Amount definition or a comparable, individually negotiated analogue.

Under normal market circumstances, this uncertainty may not raise significant concerns, or may be susceptible to mutually satisfactory resolution by the parties at the time of liquidation. However, in the case of the insolvency of one or more very significant market participants, or in circumstances of severe market stress, this uncertainty may be significant and will likely not be susceptible to contemporaneous resolution by agreement of the parties. In addition to the potentially significant adverse impacts on the close-out values of affected transactions, resulting delays and disputes could significantly impede the orderly termination and close-out of affected transactions and, in the most serious cases, contribute to market disruption and uncertainty in periods of extreme market stress.

The Policy Group believes that any close-out methodology must be measured against the need to balance the transparency and objectivity obtainable through market quotations for liquid products during normal markets, with the flexibility necessary to determine close-out valuations across a range of products and in conditions of market stress.

16a. Guiding Principle, Category I, II & III

Market participants should decide bilaterally which of the three ISDA close-out methodologies would be most appropriate in the context of their trading relationship. As market participants gain experience in the use of Close-out Amount and as products and portfolios change, market participants should continue to evaluate the efficacy of the three ISDA methodologies against the objective of achieving close-out valuations that benefit both from the transparency and objectivity obtainable through market quotations for liquid products during normal markets, and the flexibility necessary to determine close-out valuations across the range of products they trade and the conditions of market stress they are likely to confront over time.

1. Documentation Content — Other Credit Related Provisions

1999 Recommendation #17i

Delivery of Notice: Documentation should be revised as necessary to permit delivery of notice by any commercially reasonable method that is legally sound in the relevant jurisdictions (e.g., facsimile or e-mail sent with telephone confirmation satisfying sender's burden of proof as to delivery).

Update

The notice provisions of the 2002 ISDA Master Agreement were amended to provide for greater flexibility in the delivery of notices, particularly in light of technology developments over the past several years. Under the 2002 ISDA Master Agreement (as well as the 2004 IFXCO Master Agreement) notices or communications may be given in six different forms, including by facsimile and by e-mail. Notices relating to events of default, termination events and the early termination and close-out process may not, however, be given by e-mail, although they may now be given by facsimile. Use of facsimile for default and termination notices should be exercised cautiously, however, as new advances in technology have enabled facsimile communications to be sent directly to an e-mail address.

1999 Recommendation #17ii

Payment Netting: Documentation should be revised as necessary to provide for the netting of all amounts (in a single currency) that are payable on the same day. At the most elementary level, documentation should provide for payment netting across like kind transactions. To be more effective, documentation should provide for payment netting across multiple products appropriately linked under a master agreement, or by a master-master.

Update

Payment netting/matching in OTC transactions has become even more important over the past few years as trading volume has grown. Although described primarily as a documentation issue in the 1999 CRMPG I report, technological advances have allowed remarkable developments in this area. The primary driver of this technological innovation has been the credit derivatives market, where industry participants have consolidated settlement to four discrete days per year when tens of thousands of settlements are processed. Settlements occur on the 20th of each March, June, September and December, and track

settlement days used in the international money markets and on futures exchanges. The initial impetus for this settlement initiative was the desire for greater liquidity. As trading volumes have grown and new participants, including hedge funds, enter the credit derivatives market, consolidated settlement has become more challenging. Although not all parties to credit derivatives transactions use DTCC's payment netting service, described below, it greatly facilitates the process. More generally, technology and service providers have become available to facilitate speedy netting and matching in a number of product areas.

Two major service providers for payment netting are:

(a) DTCC

DTCC's DerivServ provides a cash flow matching service for credit derivatives. Through DerivServ, over twenty-five industry participants bilaterally net matched cash flows. As an example, for the March 2005 credit derivative swap quarterly settlement, DTCC processed approximately 560,000 payments with a 93% match rate. The service provides netting through a central payments database and real-time break resolution capability. Going forward, DTCC plans to implement straight through processing to settlement.

(b) SwapClear

Interest rate swap transactions are matched in Swiftnet and cleared through the LCH.Clearnet for netting and settlement. Some twenty industry participants currently net and process approximately 3,000 – 5,000 cash flows a month.

Please note: the above descriptions of service providers and services are based on publicly available information or information available from the service providers themselves.

16b. Guiding Principle, Category I, II & III

Market participants should pursue opportunities to facilitate payment netting. This may mean continuing to develop systems and operational capabilities. Equally important, where industry standard documents provide for payment netting as an option, more parties need to make this election and put it broadly into practice to take better advantage of this settlement risk-reducing mechanism.

Market participants and trade associations should also review the Group of Thirty's *Monitoring Committee on Global Clearing and Settlement* interim report, published in April 2005, which discusses progress made since the January 2003 publication of the G30's *Global Clearing and Settlement: Plan of Action*. The G30 Plan of Action and interim report provide excellent guidance in the areas of interoperability, risk management and governance with respect to global securities clearing and settlement, and should be considered in the OTC derivative context.

1999 Recommendation #17iii

Cross-Product Obligation and Collateral Netting: Parties should make the best possible use of multi-product master agreements, and master-masters, to facilitate obligation netting and collateral netting across-product lines. Where the parties do not have the ability to net collateral, documentation should be modified, subject to applicable law, to entitle the secured party to retain excess collateral to secure other obligations of the pledgor to that party.

Recommendation 17(iii) focused on the need for financial market participants to develop systems to support cross-product and collateral netting. It also recommended that documentation be modified to effect cross-product collateral netting.

1999 Recommendation #17iv

Set-off: Where permissible under applicable law, documentation should be modified to allow the non-defaulting party to exercise broad rights of set-off. These include:

- The right of the non-defaulting party to set-off against the obligations of the defaulting party.
- Obligations of the non-defaulting party to the defaulting party under other transactions or other documentation.
- Collateral or property of the defaulting party held by the non-defaulting party in connection with other transactions or under other documentation.
- Obligations of affiliates of the non-defaulting party to the defaulting party under other transactions or under other documentation.
- Collateral or property of the defaulting party held by affiliates of the non-defaulting party in connection with other transactions or under other documentation.
- Obligations of the non-defaulting party to affiliates of the defaulting party under other transactions or other documentation.
- Collateral or property of affiliates of the defaulting party held by the non-defaulting party in connection with other transactions or under other documentation.
- The right of the non-defaulting secured party to transfer excess collateral to an affiliate of the secured party to secure obligations of the pledgor to such affiliate.

In summary, Recommendation 17iv stated that documentation should be modified to allow the non-defaulting party broad rights of set-off, including the

right to net across (i) agreements, (ii) affiliates of the non-defaulting party and (iii) products, and the non-defaulting party should have the ability to apply collateral pledged by the defaulting party or its affiliates to all obligations (even those owed under agreements other than those under which the collateral was pledged) owed to the non-defaulting party and its affiliates. 17iv also recommended strengthening netting and set-off legislation to allow for broad netting and collateral setoff rights.

Update

(a) Capital, Margin and Accounting Rules

The rules relating to regulatory capital calculations published by the Basel Committee on Banking Supervision have a significant impact on financial markets. By giving recognition to cross-product netting arrangements that are legally enforceable, these rules will encourage the use of risk-mitigating tools. Similarly, cross-affiliate netting and collateral arrangements that are legally enforceable should be given recognition for regulatory capital calculation purposes.

Net capital requirements applicable to US registered broker-dealers pursuant to SEC Rule 15c3-1 should recognize the risk-reducing benefits of legally enforceable cross-affiliate netting and collateral arrangements. Margin regulations should not impede the implementation of netting arrangements that do not increase the amount of securities credit available to counterparties.

GAAP accounting principles impose differing requirements for netting different products. For example, the requirements for netting repo transactional exposures under Financial Interpretation Number 41 are inconsistent with the requirements for netting OTC derivative exposures under both GAAP rules and Basel rules, thereby increasing the potential disparity between a firm's balance-sheet disclosure and its regulatory capital calculations. The resulting added operational and accounting complexity increases operational costs, the risk of reconciliation errors and other risks inherent in running parallel accounting systems.

(b) Systems

Since 1999, most significant financial market participants have developed systems to monitor credit and collateral exposure to a counterparty on a firmwide basis. Market participants have not generally allowed set-off against affiliates of a defaulting party, however, due to concerns regarding possible regulatory issues and the enforceability of such contractual provisions in an insolvency proceeding.

(c) Documentation

Since 1999, various industry-standard agreements have been created or enhanced to allow for broad netting and collateral rights. For example, the Bond Market Association produced two Cross-Product Master Agreements, “CPMA 1” and “CPMA 2,” which are umbrella agreements intended to “sit on top” of individual master agreements or transactions between two or more parties. These CPMA’s allow for a global termination right and the netting of termination amounts across the underlying master agreements and transactions, and, in the case of CPMA 2, across affiliates. The CPMA’s also allow for the application of excess credit support provided under one master agreement to obligations owed under other master agreements.

Similarly, ISDA produced a Bridge Agreement to achieve cross-master, though not cross-affiliate, netting. ISDA has also obtained legal opinions in 45 jurisdictions confirming the enforceability of the Bridge Agreement. These initiatives have enhanced market participants’ knowledge of the legally enforceable techniques available to achieve broad netting and collateral rights, and have influenced similar bespoke agreements used in the marketplace.

(d) Legislation

Since 1999, several legislative developments have enhanced netting and collateral rights. In the United States, the passage of amendments to the US Bankruptcy Code and US bank insolvency laws to allow for broad rights to net across-products and apply related collateral to obligations owed by the insolvent party is a significant development. Outside the United States, the EU Insolvency Regulation, the related Winding-Up Directives for banks and insurance companies and the EU Collateral Directive have also increased the scope of netting rights and the right to apply related credit support. However,

as described below in our 2005 Guiding Principle for this section, uncertainties remain.

Legislation based on the ISDA Model Netting Act has been passed in the British Virgin Islands (where many hedge funds are organized), Poland, Hungary and the Czech Republic. Similar legislation is being considered by the Indian parliament and Anguilla. Enactment of favorable netting laws increases the legal certainty of netting and credit support rights of a non-defaulting party with respect to a broad range of financial contracts, including over-the-counter derivatives and securities financing transactions.

16c. Guiding Principle, Category I, II & III

Rules governing capital computations have a major impact on the breadth and depth of financial markets and financial product trading activity. It is essential that those rules favor the use of risk-mitigating tools such as cross-product netting and not restrict their use through regulatory requirements unrelated to the goal of systemic risk reduction. Intraproduct, cross-product and cross-affiliate netting and collateral arrangements should be recognized and given full netting benefit when there is a well-founded basis for believing that they are legally enforceable. Supervisory regulators should not impose additional requirements that restrict the use of such netting arrangements.

Similarly, US broker-dealer net capital and margin rules should be amended to encourage the use of netting arrangements. GAAP rules on netting should also be amended to be consistent with regulatory capital calculation rules to avoid inconsistencies between financial disclosure and capital calculations.

In the legislative arena, more work needs to be done to ensure the enforceability of netting and collateral rights with respect to certain types of counterparties that are now significant participants in financial contract markets. In particular, close-out netting and credit support liquidation safe harbors based on principles similar to those embodied in the US Bankruptcy Code should be considered and as applicable developed for government-sponsored entities, pension plans, insurance companies and similar entities, and should be crafted to ensure broad protection of close-out netting rights and to reduce systemic risk. Similarly, in view of the increased booking of financial products in different affiliates within

16c. Guiding Principle, Category I, II & III (continued)

financial conglomerates, close-out netting and collateral safe harbors should contemplate netting of a non-defaulting party's affiliates' obligations with a defaulting party. It is recommended that these initiatives be proposed to the President's Working Group for consideration and, if appropriate, sponsorship, as they will require consultation with various federal and state regulatory and self-regulatory authorities in the United States. It is also recommended that the relevant US Congressional committees and members of the US Congress sponsor the passage of amendments (embodied in the Bennett Amendment to S. 256) to make certain technical changes to the newly-enacted US bankruptcy law.

The introduction of the EU Financial Collateral Directive (the FCAD) has significantly strengthened the legal framework for financial collateral arrangements in member states of the EU. It is recommended that those few EU member states which have not implemented the FCAD do so soon. It is also recommended that the European Commission study ways to encourage greater consistency of implementation across the EU, perhaps by means of the "Legal Certainty Group" of national experts it has established in connection with its clearing and settlement initiatives. This group is examining issues relating to indirectly held securities that should further strengthen legal certainty for financial collateral arrangements.

The FCAD requires EU member states to strengthen their close-out netting regimes in collateralized relationships, but gives little guidance as to what that entails in practice. It is particularly important that guidance be given to the ten new EU accession states, some of whom have implemented the FCAD without having yet enacted netting legislation, as to the implementation of an effective regime for close-out netting. Greater convergence of existing netting regimes in the original fifteen member states would also help strengthen legal certainty in the European financial markets. It is also recommended that the European Commission resolve the uncertainties arising from differential treatment of set-off and close-out netting rights in the Insolvency Regulation and the Winding-Up Directives for banks and for insurance companies, which include inconsistent carve-outs for set-off and close-out netting arrangements.

1999 Recommendation #17v

Events of Default: Cross-default provisions in each agreement should, at a minimum, include as an event of default thereunder any default by the counterparty under any other transaction or agreement with the non-defaulting party or the non-defaulting party's affiliates. Parties should consider the need for broader cross-default provisions in individual cases.

Update

The increasing use of cross-product master agreements, such as the agreements recently developed by TBMA or the ISDA Bridge Agreement, go a long way towards accomplishing the standardized application of cross-default provisions.

The 2002 ISDA Master Agreement includes Cross-Default and Default Under Specified Transactions. As it relates to Cross-Default, a Threshold Amount must be exceeded before a default is triggered. The scope of Cross-Default may be regulated by the parties through several methods, including how the Threshold Amount is defined, how broadly or narrowly Specified Indebtedness is defined and by parties included within its scope.

Default Under Specified Transaction is designed to address defaults that occur under transactions not covered by an ISDA Master Agreement. The provision can apply to each party, their respective Credit Support Providers and any other entities that a party may want to include within the scope of the provision.

16d. Guiding Principle, Category I, II & III

Trade associations and market participants should adopt as a best practice the pursuit of cross-entity and cross-product netting and cross-default provisions in master agreements governing OTC trading relationships. Increased use of such provisions will achieve greater efficiency and reduce market and counterparty risk in default scenarios by ensuring the swift and consistent termination of transactions across-product lines.

1999 Recommendation #17vi

No-Fault Termination: Documentation should be modified as necessary to specify the consequences of events such as changes in law, changes in tax rules, regulatory changes, or governmental actions that render performance substantially more difficult or expensive or introduce substantial uncertainty.

Update

The 2002 ISDA Master Agreement modified and expanded the no-fault termination provisions of the 1992 Master Agreement. More specifically, the 2002 Master Agreement provides that a Termination Event will occur if it becomes unlawful under any applicable law: (i) for the office through which a party makes and receives payments or deliveries with respect to such transaction to make or receive a payment or delivery under such transaction or to comply with any material provision of the 2002 ISDA Master Agreement with respect to such transaction; or (ii) for a party or its Credit Support Provider to perform under a Credit Support Document. Illegality is anticipatory in that it may be triggered if it would be unlawful to make a payment or delivery or to comply on a day if the relevant payment, delivery or compliance were required on that day, even if no such payment, delivery or compliance is in fact required on that day. Changes in tax rules are covered through a separate tax-specific Termination Event.

16e. Guiding Principle, Category I, II & III

To the extent industry documentation does not already include such provisions, trade associations and market participants should make it a best practice to define clearly the termination rights of parties to OTC transactions upon the occurrence of changes in law, changes in tax rules, regulatory changes or governmental actions. A termination "road map" is particularly important in circumstances where performance would otherwise be substantially more difficult or expensive, or be subject to substantial uncertainty.

1999 Recommendation #17vii

Acts of God: Documentation should be modified as necessary to define and capture various such events to the extent that they are not clearly covered by existing provisions. It is imperative that contracts remain enforceable according to their terms, notwithstanding the occurrence of such events and that counterparties have a clear agreement at the time the contract is made as to the consequences of such events and the method of valuation in the case of such events. In no event should either party be entitled to walk away from its obligations as a result of the occurrence of such an event.

Update

A number of industry master agreements include a force majeure provision. Unlike the 1992 ISDA Master Agreement, the 2002 ISDA Master Agreement also introduced a new Force Majeure Termination Event. A Force Majeure Event differs from an Illegality in that it covers occurrences that fall outside of the definition of Illegality, but which still hinder or prevent performance of the party or its Credit Support Provider. A “laundry list” of acts considered to fall within the definition of Force Majeure Event is not provided, but “acts of state” are explicitly referenced to address actions by sovereign states, such as a foreign invasion, that may not fall within the scope of Illegality.

To constitute a Force Majeure Event, the force majeure or act of state must be beyond the control of the office, party or Credit Support Provider, as the case may be, and it must also be the case that the office, party or Credit Support Provider could not, after using all reasonable efforts (not requiring the incurrence of a material loss) overcome the relevant problem. Once a Force Majeure Event (or an Illegality) occurs, a temporary standstill generally applies in respect of affected transactions for the duration of a pre-defined Waiting Period. The Force Majeure Event does not entitle either party to walk away from its obligations as a result of the occurrence of such an event.

16f. Guiding Principle, Category I, II & III

Recent occurrences, perhaps most notably the events of September 11, 2001, have served as a reminder of the need for force majeure provisions in trading documentation. Market participants should clearly address the consequences of force majeure events, including any delays in performance, in their master agreements to minimize disruption and uncertainty in the markets. While force majeure provisions in trading documentation may allow for delays in performance, in no circumstances should any party be able to walk away from its obligations as a result of the occurrence of a force majeure event.

1999 Recommendation #17viii

Coordination: The documentation and credit functions within each firm should be coordinated to ensure that any required credit condition, such as an obligation to provide specified financial information, to maintain a specified financial condition, or to provide notice of any failure to maintain a specified financial condition, is appropriately incorporated in the firm's documentation and the consequences thereof specified.

Update

Technological and systems developments have greatly improved credit risk management and coordination between credit and documentation functions. Master agreements and "long-form" confirmations typically include credit terms, and credit approval is generally required before OTC derivative transactions may be entered into. Credit analysts and documentation specialists also work in coordination with the business and other departments as necessary when negotiating master agreements.

16g. Guiding Principle, Category I, II & III

Market participants should continue to harmonize and centralize counterparty credit risk assessment, and should strive for speedy and efficient identification of counterparty exposure across-product lines. To achieve such goals, market participants should develop systems and operational enhancements, utilize the internal audit function or other independent mechanisms and foster strong corporate governance, as appropriate. Trade associations should work with their membership to identify common concerns in this area and seek solutions.

2. Harmonization

1999 Recommendation #18

Documentation Harmonization: Industry associations should undertake an initiative to harmonize standard documentation across-products, and, where possible, jurisdictions in areas including: clauses covering notices, grace and cure periods, definitions of events of default and insolvency, and close-out valuation standards. The focus should be to:

- *Reduce notice and grace periods and make both more consistent where appropriate;*
- *Ensure that the grace period for failure to make a payment or delivery or to transfer collateral should not exceed one business day after notice;*
- *Clarify the specific points at which grace periods commence and expire to avoid confusion arising from differences in time zones, currencies of payment and close of business conventions, and the timing of notices of non-performance;*
- *Harmonize definitions of events of default and insolvency and include as broad a range of such events as possible (i.e., general inability to pay debts, written or oral admission of inability to pay, failure to pay debts as they come due, etc.);*
- *Provide for a consistent 15 day maximum cure period for involuntary insolvencies, with the ability to close-out if the counterparty has not challenged the insolvency within five days; and*
- *Improve and harmonize close-out valuation standards.*

Update

Since its creation, the Global Documentation Steering Committee has engaged in discussions and conducted a review and analysis of certain industry standard agreements with a view to harmonizing the operation of these agreements, particularly in crisis situations. This process has taken into account the experiences of GDSC members in several recent periods of market volatility.

Several industry associations, represented by their officers and staff, joined a number of market participants in the GDSC harmonization efforts. Representatives of ISDA, TBMA and EMTA (the trade association for emerging markets) participated in the full range of GDSC discussions, acting as conduits for the views of their members.

The GDSC has recommended model provisions covering the following issues:

- Cross-default (to permit termination of a relationship at the moment when other creditors may begin to seek remedies against a weakened counterparty, so that no creditors may achieve an advantaged position in either the counterparty's insolvency or its ongoing business — including expanded definitions of events of default and insolvency);
- Involuntary insolvency default (to establish a consistent definition of an “involuntary insolvency event” that appropriately accommodates the interests of defaulting and non-defaulting parties, including a standard grace period of five (5) business days as an adequate period of time to notify counterparties and offer assurances of its continuing ability to perform, notwithstanding commencement of the proceeding);
- Force majeure (to establish a uniform definition of a “force majeure event” that would capture the types of events that, while not constituting an excuse from performance or affecting the contract's enforceability, ordinarily should trigger early termination of a financial market transaction and application of an appropriate contractual methodology for determining the remaining obligations owed by the parties);
- Notice provision (to enhance the ability to give notice in crisis situations by providing for the use of any commercially reasonable method that is legally sound in the relevant jurisdictions);
- Default notice (standard forms of default notice to facilitate the ability of market participants to act quickly in response to default situations);
- Harmonization of close-out time frames; and
- A model Confidentiality Agreement.

In addition to these model provisions, the GDSC has drafted an optional “adequate assurances” clause, which is intended to provide a party with a means of protecting itself against uncertainties that do not, by themselves, otherwise constitute an enumerated event of default or termination event under the applicable master agreement or confirmation.

The GDSC has also worked on improving master agreement and related trading agreement negotiations to mitigate the risks arising from undocumented relationships, to minimize inefficiencies resulting from delays in developing beneficial trading relationships due to documentation issues and from wasted resources. Finally, there is an ongoing GDSC program to study default provisions and their enforceability.

These recommendations are generally consistent with the CRMPG I recommendations.

Of the participating industry groups, ISDA in particular, which was in the course of publishing its 2002 Master Agreement, was able to harmonize its document with several CRMPG I recommendations. In an effort to comply with the recommendations, ISDA reduced the grace period for failure to pay or deliver to one business day, and the grace period for most involuntary insolvency defaults from 30 days to 15 days. In addition, while ISDA has an array of pre-existing default mechanisms, it has modified its capital markets transaction cross-acceleration provision to include a special provision with respect to delivery failures that is intended to take account of the ordinary course treatment of individual transaction “fails” in other markets. The 2004 IFXCO Master Agreement, similarly, incorporates several CRMPG I and GDSC recommendations.

TBMA established working groups to evaluate the GDSC recommendations on cross default, adequate assurances, insolvency, notice provisions and force majeure in the context of securities transactions covered by TBMA agreements.

The BMA Working Group on cross-default decided to adopt provisions identical to those incorporated in the 2002 ISDA Master Agreement for the BMA’s standard master agreements. With respect to the adequate assurances clause, the Working Group concluded that it did not provide much additional comfort in the context of short-term, fully secured transactions, and might add ambiguity and raise legal issues such as material non-public disclosures and preference concerns under the Bankruptcy Code. Accordingly, no action was taken on the adequate assurances provision.

The BMA insolvency Working Group drafted optional “Involuntary Insolvency Amendments” which adopt verbatim the GDSC definition. However, noting that

the GDSC recommends no grace period to contest proceedings instituted by regulatory entities, the Working Group is continuing to review whether an event of default would be triggered by an insolvency proceeding filed by a regulator outside the counterparty's home jurisdiction.

With respect to the GDSC notice provisions, the BMA Working Group decided to draft conforming provisions for use as optional annexes with pre-existing standard TBMA documentation and to incorporate the provision in the CPMA 2, discussed below, which had not yet been finalized at the time. The BMA version would closely track the GDSC recommendation and be slightly broader than the notice provision in the 2002 ISDA Master Agreement with regard to the manner and deemed effectiveness of delivery.

After considering the model force majeure provision, the BMA Working Group opted not to amend the repo documentation used in the US repo markets, taking the view that, under existing documentation, market participants could rely on the ability to promptly close out a repo transaction upon the failure of a counterparty to meet its obligations. However, BMA members are considering adopting a force majeure provision in documentation used in non-US repo markets, and particularly emerging markets, where the concept of "strict performance" may not be as prevalent in the repo markets as it is in the United States.

In terms of the CRMPG I recommendations, revision of TBMA forms was not necessary on many issues, including reduced notice and grace provisions, because the recommendations were consistent with pre-existing TBMA forms. For example, TBMA agreements already provide for a grace period of one business day as well as a 15-day cure period for involuntary insolvencies.

Since 1999, various industry-standard agreements have been created or enhanced to allow for broad netting and collateral rights. More specifically, TBMA's two versions of a cross-product master agreement, CPMA 1 and CPMA 2, enable cross-product netting and margining, including among different types of securities financing transactions, and ISDA published its Bridge Agreement. (Please note that these three agreements are also discussed under the Update for 1999 Recommendations 17iii and 17iv.)

In general, both CPMA 1 and CPMA 2 are bilateral, "master-master" agreements that provide cross-defaults, termination rights and the netting of termination

amounts across the underlying master agreements, covering TBMA-sponsored agreements as well as other master agreements such as the ISDA Master Agreement. CPMA 2 goes further to allow netting across affiliates. Similarly, the ISDA Bridge Agreement is a cross-product master-master agreement that functions much the same as does TBMA's CPMA I. By providing for cross-default among the covered agreements, these cross-product agreements facilitate the reduction in documentation basis risk.

Finally, the GDSC plans to examine whether the different definitions of "business day" merit a documentation harmonization effort.

17. Guiding Principle, Category II

The productive discussions in the markets in relation to the 1999 recommendation of CRMPG I on documentation harmonization should intensify. The fundamental mission of the GDSC, which was created as an outgrowth of CRMPG I, was to harmonize documentation standards and reduce documentation basis risk, and market participants should accordingly make it a best practice to facilitate harmonization and consistency in documentation standards. To that end, new standards should be incorporated in existing documentation to the extent possible, and new documentation should be used on a forward basis. Market participants should work cooperatively with trade associations to achieve greater harmonization.

3. Collateral Management

Update

Since 1999, use of collateral on a bilateral basis has increased dramatically, and has served to mitigate counterparty and market risk accordingly. Discrepancies in timing for margin calls and for closing out counterparties remain, although there have been efforts to standardize such provisions. The availability of master-master agreements, together with the use of industry standard credit support or margining arrangements, that provide for collateralization across products and across underlying master agreements have provided more consistency in margining, as has a recent trend to VAR margining.

18. Guiding Principle, Category II

Collateral managers and other market participants should explore the development of standardized, automated processes for clearing, settlement and portfolio reconciliation of high volume "vanilla" OTC products.

D. Credit Derivatives

1. The Role and Impact of Credit Derivatives on the Financial Markets

Credit derivatives were not addressed in the 1999 CRMPG I report as a significant documentation issue in their own right. While credit derivatives were traded in 1999, the size of the market, the scope of transactions and the varied uses of credit derivatives were not nearly as broad as they are today. In evaluating the current state of the derivatives markets and its infrastructure, it is impossible to ignore the impact of credit derivatives on the financial markets. We have therefore included a brief discussion of credit derivatives in this update as a new topic. The subject of credit derivatives is discussed in much greater detail in Section V and Appendix A of this Report as part of the much broader discussion of complex financial products.

Broadly speaking, credit derivatives are financial instruments that transfer all (or a portion) of the credit risk of an underlying obligation or entity (or group of obligations or entities) from one party to another party without necessarily transferring the underlying asset.

When the CRMPG I report was published in June 1999, the credit derivatives market was in an early phase of development. Over the past six years, the credit derivatives market has grown exponentially in terms of transactional volumes. As of the end of 2004, the estimated size of the credit derivatives market (based on notional amount outstanding) was over \$5.0 trillion (as reported in the ISDA 2004 ISDA Year-End Survey). Equally importantly, the range of market participants in the credit derivatives market has grown significantly and now includes a wide variety of banks, insurance companies, hedge funds, pension plans and asset managers. The range of credit derivative products has also grown considerably and now covers a wide variety of products and transactions including “nth-to-default” transactions, credit index products and various correlation products.

Credit derivatives have become important risk management tools for market participants by allowing borrowers, lenders and intermediaries to assume or distribute credit risk in a customized fashion. In addition, credit derivatives have become important measures of credit risk and are increasingly used to assist in the pricing of loans and securities in the primary and secondary cash markets.

Credit derivatives have also emerged as important sources of liquidity for cash market investors and intermediaries, particularly with respect to illiquid cash instruments.

(a) Joint Forum Report

The growth of the credit derivatives market and its impact on the financial markets have not gone unnoticed by industry observers or regulators. In March 2005, the Joint Forum released a report entitled *Credit Risk Transfer*, which addressed a number of key issues relating to the use of credit derivatives. In summary, the Joint Forum's report concluded that (i) credit derivatives had achieved a relatively good record, to date, of "cleanly" transferring risk, (ii) market participants seemed largely aware of the risks associated with credit derivatives and (iii) the credit derivatives market does not appear to have produced any "hidden concentration" of credit risk. These conclusions are generally consistent with various rating agency surveys of the credit derivatives markets.

The Joint Forum's report also included seventeen recommendations relating to risk management practices, disclosure and supervisory practices applicable to credit risk transfers. These recommendations are consistent with sound risk management principles for the derivatives markets that have been previously endorsed by various groups, including the Group of Thirty in 1993 and the CRMPG I in 1999.

In addition, the Financial Services Authority in the United Kingdom has raised the issue of unsigned credit derivatives confirmations as a concern. The issue of unsigned confirmations generally is addressed elsewhere in this Report, most notably in Recommendation 12.

19. Recommendation, Category I

CRMPG II recommends that financial intermediaries and end-users of credit derivatives redouble their efforts to ensure that they fully understand the nature of their credit derivative transactions and the similarities and differences between those transactions and other credit positions and exposures. In this regard, it is very important that market participants be thoroughly familiar with the terminology used to document credit derivatives, and the nuances surrounding various terms.³ Market participants should be aware that credit derivative transactions may intentionally or unintentionally give rise to other risks, including retained credit risk, counterparty credit risk, legal risk, operational risk and concentration/liquidity risk.

³ (Unless otherwise defined herein, capitalized terms have the meanings used in ISDA's 2003 Credit Derivatives Definitions.) In a standard credit default swap, the "buyer" of the protection agrees to make periodic payments to the seller of the protection in exchange for the seller's commitment that, upon the occurrence of certain credit default-related events with respect to a named legal entity (the "Reference Entity"), the buyer will have the right to deliver loans or securities to the seller in exchange for an agreed upon amount (typically par). The events that parties most frequently agree to as triggering events are "Bankruptcy," "Failure to Pay," "Repudiation/Moratorium" (for sovereigns only) and "Restructuring," each of which is a complex defined term under the ISDA's 2003 Credit Derivatives Definitions.

(b) Retained Credit Risk

Market participants should recognize that credit derivative transactions generally transfer credit default risk, which is not necessarily identical with the price risk associated with credit risk. To the extent that a “Reference Entity” does not “default” within the meaning of the relevant credit derivative transaction, the buyer of protection will retain the credit risk of the Reference Entity. This is particularly relevant where the term of the credit derivative transaction is less than the term of the obligations that the buyer of protection is seeking to hedge. The definition and scope of a “default,” therefore, is critical.

(c) Counterparty Credit Risk

Most credit derivative transactions involve some degree of counterparty credit risk. In a credit default swap, the most significant counterparty credit risk is typically borne by the buyer of protection who is exposed to the risk that the seller of protection will default on its obligations following the occurrence of a credit event with respect to the Reference Entity. Less obvious, but equally real is the risk that the buyer of protection will fail to make whatever payments the buyer may be required to make over the term of the credit derivative transaction.

Most market participants seek to mitigate counterparty credit risk by limiting their dealings to well capitalized counterparties and/or requiring initial and/or mark-to-market collateral. The use of collateral to mitigate counterparty credit risk is generally effective, provided that the secured party uses accurate values and requires any collateral deficiencies to be promptly cured. Alternatively, buyers of credit protection can largely eliminate counterparty credit risk by issuing credit linked notes, which effectively are fully collateralized credit default swaps.

One notable trend in the credit derivatives market is the increased participation by hedge funds and other leveraged counterparties as sellers of credit protection. This increased participation should serve to diversify counterparty credit risk in the credit default market. At the same time, such participation may marginally increase counterparty credit risk due to some hedge funds’ leveraged nature.

(d) Basis Risk

Market participants should be aware that there may be important differences between different types of credit derivative products (e.g., credit default swaps, credit-linked notes or bond options). In addition, there are frequently important differences in contractual terms and market conventions between credit derivative products and other financial products or transactions that involve transfers of credit risk (e.g., surety bonds, guarantees or participations). For example, the buyer of credit protection in a credit derivative transaction is not required to have a credit exposure to the Reference Entity or to demonstrate that the buyer sustained a loss as a consequence of the occurrence of a Credit Event with respect to the Reference Entity. In the case of financial guaranty insurance, the insured must have an insurable interest and is only entitled to be reimbursed for actual losses sustained as a result of the default. These differences can become very important where a market participant is seeking to offset risks using different products. For example, three or four years ago, certain dealers used credit default swaps to buy or sell protection and hedged their position through financial guaranty insurance from monoline insurers or reinsurance contracts with reinsurance companies.

Market participants that are seeking to hedge the credit risk associated with a specific asset should also be aware of differences between the credit derivative transaction and the hedged asset. For example, most credit derivative transactions impose various requirements (e.g., maturity, currency or transferability) on the types of obligations that may be delivered in connection with the settlement of the transaction.

(e) Legal Risk

According to a September 2004 report by Fitch Ratings, approximately 14% of credit events captured in a recent Fitch survey were reported to involve some form of legal dispute. While the vast majority of these disputes have been resolved privately, a handful of disputes have resulted in litigation.

Most of these disputes appear to have involved contractual claims relating to one of the following issues: (i) the identity of the Reference Entity that is the subject of the transaction, (ii) whether a particular event qualified as a Restructuring or Repudiation/Moratorium so as to trigger a Credit Event

under the transaction, (iii) the timeliness of notices delivered under the transaction, (iv) the nature of assets that may be delivered under the transaction or (v) the timeliness of deliveries of assets in connection with the settlement of the transaction.

The industry has reacted to these disputes in a number of different ways, including by developing a centralized database of Reference Entity names and modifying industry standard definitions to clarify provisions or offer the parties an opportunity to choose between alternative approaches, and by publishing guidance regarding the settlement process following the occurrence of a Credit Event.

In some instances, the disputes have involved assertions that one of the parties breached fiduciary duties owed to its counterparty, the risks associated with the transaction were not adequately disclosed or the transaction was not suitable for the counterparty. Market participants — particularly dealers — should be sensitive to the potential legal, regulatory and reputational risks associated with credit derivative transactions, particularly when dealing with less sophisticated counterparties.

20. Guiding Principle, Category I & II

Industry participants should continue to identify potential areas of confusion or misunderstanding and seek to develop or refine market practices or conventions, and the accompanying documentation, to eliminate or mitigate such areas of confusion or misunderstanding.

(f) Operational Risk

Credit derivatives can give rise to significant operational risk due to their complexity. As noted elsewhere in this Report, it is important for market participants to promptly and accurately confirm the terms of their transactions, including assignments.

As noted earlier, the volume of credit derivative transactions has been growing at exponential rates over the past few years and there is no reason to believe that this growth will diminish in the near term. In fact, the introduction of standardized credit indices and baskets suggests that with respect to certain Reference Entities, the volume of outstanding transactions will continue to grow rapidly. As a result, upon the occurrence of a Credit Event with respect to one of these Reference Entities, market participants (primarily dealers) would need to bilaterally settle thousands of transactions. Whether credit derivative transactions provide for cash or physical settlement, the settlement process is largely manual and operationally very resource intensive for market participants and is not readily scalable. Individual exercise notices must be prepared and delivered and either separate cash settlement auctions conducted or separate physical settlements executed. Thus far, the industry has had very limited experience with settling large numbers of transactions following a Credit Event, and such occurrences have generally not involved the settlement of more than a few hundred transactions for any single market participant. However, in the case of a recent Credit Event with respect to a Reference Entity included in several highly traded credit indices, some market participants needed to settle several thousand transactions. As the number of outstanding transactions continues to grow, the occurrence of a Credit Event with respect to a popular Reference Entity could put a material strain on the ability of market participants to settle transactions in a timely and efficient manner.

Settlement issues could also arise in situations in which the volume of credit derivative transactions materially exceeds the supply of bonds or loans that qualify as deliverable obligations under the credit derivative transaction. Moreover, to the extent that there are multiple qualifying deliverable obligations, it may be more advantageous to receive or deliver certain obligations. As a result, market participants should be aware of the possibility

that qualifying deliverable obligations may be difficult to locate following a Credit Event.

21. Recommendation, Category II

CRMPG II recommends that industry participants build on the experience gained through recent ad hoc multilateral initiatives and work to develop a standardized multilateral process for the exercise and settlement of both outstanding and future credit derivative transactions on a simultaneous net basis. The development of such a process should consider the use of electronic platforms to reduce the strain manual settlements place on the back-office resources of market participants and to further transition the market toward straight through processing.

(g) Trade Assignments

The ability of market participants, particularly end-users, to assign over-the-counter derivative trades has long been an important source of liquidity in the market. Nonetheless, the ability of market participants to establish negotiated credit terms to manage counterparty credit risk and to otherwise manage their trading relationships is also important to the integrity of the market. Consequently, most industry standard over-the-counter derivatives documentation provides that a party must generally obtain the prior written consent of their counterparty before assigning a transaction to a third party. Along with the dramatic increase in the volume of credit default swap trading, many market participants have increasingly relied on trade assignments for both liquidity and price discovery. This practice is particularly prevalent with respect to credit default swaps where trade assignments may account for as much as 40% of current trade volumes. In the current credit default swap market, assignments routinely occur without the prior written consent of the original trade counterparty. Additionally, the original counterparty to the trade may not receive timely notice of the assignment, and it is also often difficult for any of the three parties to an assignment to obtain executed assignment documentation. This lack of consent to a trade assignment may introduce uncertainty as to the status of the transaction. The lack of notice may also introduce uncertainty as to the identity of the trade counterparty, undermine counterparty credit and market risk metrics and impede back-office trade reconciliations leading to a higher incident of settlement fails and collateral breaks. The increase in unconfirmed transactions (also noted in connection with Recommendation 12), combined with the frequency with which credit default swaps are traded, has resulted in some assignments occurring prior to the confirmation of the trade by the original parties, thereby increasing the risk of potential disputes with respect to the status and the terms of a transaction. The market is keenly aware of the issues associated with the lack of consent to trade assignments and market participants, together with industry groups, are actively taking steps to address the situation.

22. Recommendation, Category II

Trade assignments require the same rigorous controls and discipline as new transactions. It is critical that market participants know their counterparty, and therefore, prior consent to assignments must be obtained. Specifically, CRMPG II recommends that market participants should not assign or accept assignments of transactions without the consent of all three parties. All market participants should initiate and take part in industry initiatives designed to facilitate compliance with the prior consent requirement. Industry efforts in this regard should include the use of electronic platforms to further the transition of the market toward straight through processing of assignments. With respect to existing assignments, CRMPG II urges market participants to dedicate substantial resources to ensure that these assignments are properly identified and properly documented.

CRMPG II recognizes that the prospective practices described above will require a transitional period and that it would be unreasonable to expect full implementation immediately. Nonetheless, these goals should be achieved in the near term and, in the interim, market participants should keep senior management apprised of the progress being made in identifying and documenting assignments.

2. Potential Influence of Credit Derivatives on Underlying Cash Markets

Market participants should be aware of the potential impact of credit derivatives on the underlying cash instruments, particularly when the Reference Entity is in financial distress. For example, creditors of a financially distressed Reference Entity may be asked to agree to grant waivers of various types of defaults or to amend the terms of the Reference Entity's indebtedness. To the extent that such creditors have entered into credit derivative transactions with respect to the Reference Entity, the creditors' decisions with respect to such waiver or amendment requests may be influenced by the creditors' cash and derivative exposures to the Reference Entity. In some cases, it may be possible to structure a waiver or amendment such that it either will or will not constitute a "Credit Event" under market standard definitions. As a result, market participants should be aware of the potential interplay between the terms of a proposed waiver or amendment request and credit derivatives.

The existence of credit hedges may also have a significant impact on workout situations. To the extent that a creditor has hedged a substantial portion of its credit exposure to a Reference Entity that is in financial distress, the creditor's actual credit exposure to the Reference Entity may be significantly different than its cash position in obligations of the Reference Entity. Moreover, the seller of credit protection may have substantially greater credit exposure to the Reference Entity than its cash positions. Accordingly, market participants should be sensitive to the potential impact that credit derivative transactions may have on apparent and actual credit exposure of a Reference Entity's creditors.

E. Implementation and Progress

Documentation standards are qualitative rather than quantitative, and it is therefore difficult to measure progress in the reduction of documentation basis risk. Nonetheless, since 1999, steps have been taken to address documentation basis risk by institutions active in the OTC markets. Improvements include better documentation practices through greater awareness of documentation basis risk and documentation content, and the adoption of formal and informal documentation policies; the expansion of staffing in documentation units to include individuals with a high degree of documentation expertise; and the implementation of new systems and tools to track documentation status and measure exposures. These enhancements,

along with greater emphasis on straight through processing, have reduced or mitigated the risks associated both with documentation basis risk and explosive trade volumes.

The Recommendations made and Guiding Principles established in this Report represent another large step forward in strengthening the global financial infrastructure and thus contributing to the goal of financial stability. As with the 1999 recommendations, most of the 2005 Recommendations and Guiding Principles will require closer coordination between individual institutions, industry trade associations and official institutions.