Towards **T+0** reconciliation

The Counterparty Risk Management Policy Group's third major policy statement appeared in early August – and it presents surprisingly radical demands, says ***David Rowe***

Periods of crisis always prompt bouts of soul searching and critical evaluation. The continuing economic gloom has already produced a number of these, most notably *Observations on risk management practices during the recent market turbulence*, by the Senior Supervisors Group (*Risk* July 2008, page 75[1]). In August, the Counterparty Risk Management Policy Group (CRMPG) issued its third major policy statement, entitled *Containing systemic risk: the road to reform*, widely referred to as CRMPG III.

Some of the points made in CRMPG III are neither new nor surprising. It emphasises that financial market excesses are rooted in collective human behaviour that tends towards unbridled optimism on the upside and pervasive fear on the downside. It properly identifies a sound corporate culture, constantly reinforced by words and actions from the top, as the essential prerequisite for successful risk management. It emphasises independent reporting lines for risk managers and the need for compensation schemes that encourage attention to risk alongside aggressive pursuit of higher profits.

It also highlights the need for the board to set the risk appetite of an institution based on an informed understanding of both quantitative and qualitative inputs.

Beyond these points, however, CRMPG III issues a welcome call for a number of specific innovations. Some of these are surprisingly radical in their scope and proposed speed of implementation. One of these is a demand that "all large integrated financial intermediaries must have, or be developing, the capacity… to monitor risk concentrations to asset classes as well as estimated exposures, both gross and net, to all counterparties in a matter of hours".

It further says: "Within a slightly longer time frame, this information should be expandable to include: (1) the directionality of the portfolio and of individual trades; (2) the incorporation of additional risk types, including contingent exposures and second- and third-order exposures (for example, structured investment vehicles and asset-backed securities); and (3) such other information as would be required to optimally manage risk exposures to a troubled counterparty." This clearly implies the mark-to-market plus add-on approach to counterparty exposure is unacceptable. Exposure sensitivity to hypothetical market events is part of the expected risk management data.

Related to the previous demand is an even more breathtaking challenge. CRMPG III says: "The industry and its major market participants need to implement tools and practices that achieve a same day (T+0) standard for confirmation and regular ongoing reconciliation of positions, settlements and mark-to-market values." It is proposed this be in place by the end of 2009.

No-one can dispute the immense value of accomplishing this. It would effectively merge the affirmation and final confirmation steps into reconciliation of a legally binding electronic trade record on a daily close-of-business basis. This would improve the reliability of daily market and credit risk assessments, significantly reduce the current amount of time spent on dispute resolution and, very significantly, it would be the basis for a commercially reasonable and operationally orderly close-out procedure in the case of the failure of a major market participant.

Another important benefit is not mentioned in the CRMPG III report. The proposed T+0 reconciliation process would make the type of fraud perpetrated last year at Société Générale much harder to sustain. A permanently rotating pool of unconfirmed transactions muddies the water and complicates efforts to detect bogus trades used to hide unauthorised open positions. Discrepancies in total deal counts and notional amounts would be easier to detect if all major bilateral positions were reconciled daily.

There are, however, huge obstacles to achieving this goal. The technological challenges are overwhelming given the continuing massive fragmentation of data in all large financial institutions. Perhaps more significant, it is hard to see how continuing the current haphazard practice of trading complex new transactions that only exist on spreadsheets is compatible with such a system. It will be interesting to see if major market-makers are prepared to abide by a process that constrains unbridled product development in this way. ■

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[1] *www.risk.net/public/showPage.html?page=802942*