Derivatives Regulation

UK legal and regulatory developments

Regulatory concerns relating to operations and risk management in the credit derivatives market

Jonathan Marsh

Hunton & Williams, Fleetway House, 25 Farringdon Street, London EC4A 4AB,
Tel: +44 (0)20 7246 5705; Fax: +44 (0) 20 7246 5772; E-mail: jmarsh@hunton.com

Jonathan Marsh is a partner in the London office of US law firm Hunton & Williams LLP, where he specialises in UK and EU financial markets law and regulation. A former senior legal adviser at the Securities and Futures Authority and deputy general counsel at the London Metal Exchange, Jonathan has extensive experience of advising financial markets participants including derivatives traders, banks, brokerage houses and asset management companies on obligations arising under the Financial Services and Markets Act 2000, the Financial Services Authority's rules, anti-money laundering laws and the rules of Recognised Investment Exchanges. Jonathan sits on the Futures and Options Association's compliance committee and metals working group, and is a member of the Association of Regulatory and Disciplinary Lawyers.

INTRODUCTION

In February 2005, the Financial Services Authority (FSA) published a 'Dear CEO' letter, in which it set out a number of concerns relating to operations and risk management in the credit derivatives market. The letter was published following market soundings undertaken by the FSA of the operational activities of a number of firms engaged in the credit derivatives market. This activity itself followed international enquiries into credit derivatives, including an investigation by the Joint Forum¹ which resulted in the publication in October 2004 of an extensive report on credit risk transfer (the Joint Forum Report).

Regulatory investigations are not the only reason for credit derivatives generating

recent news reports. In February 2005, Reuters reported that derivatives litigation was set to explode. This followed news of Barclays Capital settling a claim by Germany's Nord Bank over a US\$151m collateralised debt obligation (CDO). The concerns over an increase in the number of credit derivatives-based lawsuits arise from a fear that, if credit spreads widen as a result of predicted interest rate rises, a number of investors will incur significant losses and may be tempted to litigate. Such claims might be based on the grounds that parties were mis-sold unsuitable credit derivatives or that there had not been adequate disclosure of the risks.

In the light of well-publicised regulatory concerns, participants in the credit derivatives market will need to be extra

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vigilant in ensuring that they are complying with their regulatory obligations. This is because, having drawn specific attention to issues that they regard as meriting action in the ‘Dear CEO’ letter, the FSA is likely to take a very dim view of firms perceived to have ignored their concerns. The purpose of this article is to look at the exact nature of the regulatory concerns and the steps that firms should take to address them.

FSA RULES AND GUIDANCE ON RISK MANAGEMENT IN THE CREDIT DERIVATIVES MARKET

The FSA sets great store by sound risk management. Principle 3 of the FSA’s ‘Principles for Businesses’ provides that a firm must take reasonable care to organise and control its affairs responsibly and effectively, using adequate risk management systems. This requirement is supplemented by the FSA’s Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) which, among other things, states that a firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business.²

The FSA’s Interim Prudential Sourcebook provides specific guidance on risk management in the credit derivatives market.³ According to this guidance, a firm’s internal controls should include a product approval process which, among other things, should involve consideration of the following factors:

- whether the new business falls within the firm’s risk appetite

- an exact description of the type of product to be introduced
- accounting policies
- valuation methodology and systems for ensuring adherence to the policy
- authority and level of knowledge of risk managers and/or independent price-checkers
- format and content of risk reports
- limits and systems for measuring/monitoring usage of those limits
- type of documentation to be used and other legal risks
- clearing and settlement procedures
- adequacy of the firm’s computer systems for representing the new transaction types
- reliance on key staff
- risks arising from the remuneration strategy.

The FSA’s guidance also provides that adequate risk management systems are likely to include:

- adequate management information systems to make senior management aware of the risks being undertaken
- procedures for ensuring that a credit risk of a reference asset acquired through a credit derivative transaction and any counterparty credit risk is captured within the firm’s normal credit approval and monitoring regime
- systems to assess and take account of the possibility of default correlation between the reference asset and the protection provider
- valuation procedures and procedures to

determine an appropriate liquidity reserve to be held against uncertainty in valuations.

The FSA's guidance on risk management does not provide a detailed analysis of the risks associated with credit derivatives and should be viewed as a set of minimum expectations rather than best practice. A more in-depth review of the risks is provided by the Joint Forum Report which is discussed below.

SPECIFIC CONCERNS RAISED IN THE 'DEAR CEO' LETTER

The FSA's 'Dear CEO' letter identified two principal areas of concern, namely outstanding confirmation, and calculation and paying agent communications. As far as the former is concerned, the FSA's specific concern related to its discovery of high levels of unsigned confirmations which, according to the FSA, raises 'serious issues for market efficiency and market confidence'. The FSA did not elaborate on this, but it is reasonable to infer that the main concern was the lack of legal certainty that unsigned confirmations give rise to. While it is of course right that parties should aspire to execute confirmations as soon as practicable after entering into a transaction (and, indeed, are required to do so under the terms of an International Swaps and Derivatives Association (ISDA) Master Agreement⁴), it is worth pointing out that, although an unexecuted confirmation may create evidential problems if there is a dispute about agreed terms, it should not affect the

enforceability of the transaction as long as the key terms are sufficiently certain.

The other specific issue raised in the FSA's letter was based on its view that the communication mechanism between calculation agents and paying agents for disseminating rate-fixing information used for calculating interest and principal payments is not always effective. Ineffective communications could lead to problems in notifying custodians and investors of impending cash movements. Accordingly, calculation agents were asked to ensure that they have in place an effective system for advising paying agents and issuers on a timely basis of all rate or index determinations.

As well as being concerned about the specific issues referred to above, the FSA also voiced general concerns about the lack of sufficient back office resources being devoted to credit derivatives. The 'Dear CEO' letter refers to the FSA's belief that more could be done to reduce operational and settlement risks and the fact that its investigation confirmed the Joint Forum's findings that back-office functions are not keeping pace with rapidly developing front office trading activity.

Regardless of how justified the FSA's concerns are, participants in the credit derivatives market will need to take heed, as there can be little doubt that the FSA will follow up on its review, and any firm found to be wanting as far as back office resources are concerned will run a real risk of FSA enforcement action. This is of particular concern for senior managers, who are approved persons responsible under SYSC 2.1.3(2) for overseeing the obligation

to maintain appropriate systems and controls in areas of the business which include credit derivatives. If the FSA deems those systems of controls to be inadequate, those individuals could be subject to disciplinary action in their capacity as approved persons for a breach of Principle 7 of the FSA's Statement of Principles for Approved Persons.⁵

THE JOINT FORUM REPORT

The Joint Forum Report contains an extensive review of the risks associated with credit risk transfer instruments and makes a number of recommendations in relation to risk-management practices, disclosure and supervisory approaches. The Report repeats a principle stated in previous reports on derivatives risk,⁶ namely that senior management and the board of directors bear ultimate responsibility for the activities and risks undertaken by the organisation, and the Report recommends that market participants should use credit risk transfer instruments in a manner consistent with the overall risk management framework approved by their board of directors or equivalent senior management body and implemented by their senior management.

Credit risk

The first specific risk referred to in the Joint Forum Report is credit risk. For the purposes of the Report, credit risk means the underlying credit risk that is being transferred, as distinct from the counterparty credit risk that arises from the possibility that the counterparty to the transaction will be unable to perform as contracted over

the life of the transaction. The Report makes the point that the underlying credit risks associated with credit default swaps are similar to those associated with loans or bonds and that, as a result, the risk management challenges are similar. For example, a firm that actively trades credit default swaps would typically look at its positions from a market risk perspective, focusing on the daily change in market value and using value-at-risk and/or stress tests to evaluate the risk of a position in much the same way that a firm actively trading bonds would evaluate risk.

In contrast to credit default swaps, the risk management challenges arising from CDOs are viewed as more onerous. This is because, in a CDO, the credit risk of a portfolio of exposures is transferred through credit default swaps and 'tranching' into different segments, each with unique risk and return characteristics. For dealers involved in more complex CDO transactions, the key challenge is to ensure that they are truly as well-hedged as they intend to be. According to the Report, this means that they must pay careful attention to the underlying models and assumptions they are using, especially in relation to the assessment of the underlying correlation of the different referenced entities.

In order to ensure that credit risk is being adequately managed, the Joint Forum makes two recommendations. First, market participants should have the capacity to understand and access the credit-related risks inherent in the credit transfer instruments they trade. This should include the capacity to understand the major variables on which the valuation of the

instrument depends and how its valuation will be affected by changes in these variables. In addition, market participants should seek to ensure that their measures of credit exposures to individual obligors are as comprehensive as possible, eg by including both direct exposures (such as loans) as well as indirect exposures arising from credit derivatives transactions.

The Report's second recommendation on credit risk management is that firms that rely on models to assess the valuation and risks of credit derivatives should have sufficient staff and expertise properly to understand the assumptions and the limitations of these models, and to manage their usage appropriately. According to the Joint Forum, the use of such models should be subject to periodic validation, independent of the trading or business area, and firms should try regularly to compare model-based valuations with available market proxies and/or valuations of similar instruments produced by other firms.

Counterparty credit risk

The second specific risk covered by the Joint Forum Report is counterparty credit risk. The Report recommends that counterparty credit risk arising from unfunded credit derivative positions should be actively managed through at least daily calculation of exposures and that all exposures to the same counterparty — including those arising from instruments other than credit derivatives — should be aggregated, taking into consideration legally enforceable netting agreements. In addition, the Joint Forum recommends that all counterparties, regardless of collateral status,

should be subjected to a rigorous due diligence process which, in the light of the rapidly growing market in credit derivatives and corresponding drain on resources, should include an assessment of operational capabilities.

Legal risk

The third main area of risk identified by the Joint Forum is legal risk. The widespread use of ISDA Master Agreements has had a significant effect on mitigating legal risk, and comfort can be taken from the fact that large default events, such as Enron and WorldCom, did not lead to material litigation in relation to the credit default swaps written on those entities using ISDA documentation. Key areas of legal risk remain, however.

The Joint Forum Report cites restructuring as one of the most significant areas of legal risk. Because a credit default swap contract often calls for physical settlement by delivery of an obligation of the referenced entity following a default, it contains an implicit cheapest-to-deliver option. Initially, the ISDA documentation incorporated restructuring as an event of default without specifying very narrowly which obligations were eligible for physical settlement. Various market events caused ISDA to revisit its restructuring definitions and to restrict still further the securities eligible for physical settlement in the event of a restructuring. Subsequently, there were further revisions in response to concerns that the original revision was too restrictive. Consequently, three different types of restructuring language

are now used in the market place, which, according to the Joint Forum, segments the market somewhat.

Another legal risk referred to in the Report arises where market participants enter into contracts on the wrong legal entity. In the light of this and the restructuring issue discussed above, the Joint Forum recommends that all market participants pay careful attention to the legal documentation relating to credit risk transfer instruments, such as the range of credit events covered by the instruments, and to the clear and ambiguous identification of underlying reference entities. In addition, the Report calls for the aggressive continuation of efforts towards standardisation of documentation, particularly as far as synthetic CDO-related transactions are concerned, in relation to which there are a great variety of structures and legal documentation. In making this point, the Joint Forum noted the work done by the Bond Market Association in developing the CDO Transaction Library, a compilation of deal documents on specific transactions.

Yet another area of legal risk identified by the Joint Forum concerns the possibility of disputes by counterparties or customers on the basis of failure adequately to disclose or advise on the risks inherent in the transaction. As noted above, there are concerns that credit derivative-based litigation is on the increase. This risk grows as product structures grow more complex. A key issue in determining the degree of litigation risk relates to whether the dealer has any obligation to provide information about the transaction or to assess its appropriateness for the counterparty. In

order to reduce the degree of litigation risk, the Joint Forum recommends that, before entering into a transaction, market participants should undertake the due diligence necessary clearly to identify their legal responsibilities to the counterparty or customer, based on their role in the particular transaction, and to determine whether their counterparty or customer has legal authority to enter the transaction. In the light of previous well-publicised cases related to the capacity to enter into interest rate swaps,⁷ the derivatives trading community is very much alive to capacity issues and one would not normally expect to see this part of the due diligence process overlooked.

As far as claims based on inadequate disclosure or advice are concerned, dealers can take some comfort from the fact that there is no general duty in a trading relationship for one party to ensure that the other understands the risk involved in a transaction or to establish its suitability for the other.⁸ That said, there are some circumstances in which a duty of care will arise in the context of a trading relationship, eg if it is clear that one party is looking to the other for advice. In order to reduce liability risk, it is common practice to represent in transaction documentation that each party has made its own assessment of the risks involved.⁹ Notwithstanding the lack of a general duty to advise or explain and an ability to limit liability in the manner described above, the Joint Forum recommends that, when marketing structured credit risk transfer products, originators and dealers should seek to foster a complete understanding of

the nature and material terms, conditions, and risks involved and should not encourage exclusive reliance on external ratings as a measure of risk associated with the transaction. The Report also recommends that, before entering into a credit risk transfer transaction, investors should ensure their ability to obtain, both at the outset and on an ongoing basis, the necessary information properly to evaluate and manage the risks associated with their investment.

The final area of legal risk discussed in the Joint Forum Report relates to the question of how banks that participate in the credit risk transfer markets as both hedgers and market-makers control access to confidential information obtained from customers with which they have lending or other business relationships. Banks are subject to a duty of confidentiality to their customers¹⁰ and, in the absence of obtaining the reference entity's consent, it would normally be a breach of this duty for them to disclose information about a customer's credit standing to a credit derivatives counterparty.

Another reason for having to control access to confidential information is that, in some jurisdictions at least, making use of such information, for example to trade ahead of other market participants either in a credit hedging capacity or in the institution's trading area, could lead to criminal or regulatory liability. In the UK, Part V of the Criminal Justice Act 1993 makes it a criminal offence for anyone to deal on certain stock exchanges or through (or while acting as) a professional intermediary in securities which are covered by the Act

while in possession of price-sensitive inside information.¹¹ As 'securities' covered by the Act include debt and equity securities which are admitted to trading on one of a number of specified exchanges (and derivatives over them), entering into a credit derivative transaction or related hedging transactions on the basis of unpublished price-sensitive information may amount to insider dealing within the meaning of the Act. Additionally, such behaviour could amount to market abuse within the meaning of section 118 of the Financial Services and Markets Act 2000 (FSMA) if the confidential information relates to certain types of investments, such as bonds or equities, falling within the market abuse regime.¹² Although market abuse does not amount to a criminal offence, the FSA has the power to impose civil penalties on anyone who breaches the regime.¹³

In the light of the legal risks associated with confidential information, it is not surprising that the Joint Forum Report recommends that market participants, especially banks that lend to firms referenced by credit risk transfer instruments, should take care to ensure compliance with all relevant laws and regulations as well as industry recommendations concerning the use of material non-public information as it relates to their participation in credit risk transfer transactions.

Operational risk

The fourth distinct area of risk identified by the Joint Forum focuses on operational risk, the area that prompted the FSA to send its 'Dear CEO' letter. The Joint Forum cited

the backlog of unsigned master agreements and unsigned confirmations, as well as the prevalence of manual systems, as issues giving rise to documentation and settlement risk. The Report recommends that execution of transaction documentation should be carried out promptly after agreeing the transaction, and that market participants should ensure that their credit risk transfer activities are undertaken by sufficient numbers of professionals with appropriate skills and experience. Significantly, the Report also recommends that regulators should reinforce that material backlogs of unsigned documentation are unsound by requiring market participants that are unable or unwilling to manage their volume of transactions to adopt corrective measures. Clearly, the FSA's investigation was a reaction to this recommendation and, as noted above, it is likely that the FSA will revisit this area once firms have had an opportunity to react to its letter.

Market liquidity risk

The final area of risk with which the Joint Forum deals is market liquidity risk. Specifically, the Joint Forum noted that, whereas there were good levels of liquidity in the credit default swap market, secondary market liquidity for CDO tranches was poor. As a result, the Joint Forum recommends that market participants should understand the liquidity characteristics associated with the credit risk transfer positions they have taken and, in particular, that investors in CDOs and other structured products should be aware of the limitations on secondary market activity associated with such instruments.

THE FUTURE

The Joint Forum Report's recommendations as to how market participants should manage the risks associated with credit risk transfer instruments are not groundbreaking and will be familiar to firms with experience of trading derivatives. Although not particularly significant in terms of innovation, the recommendations are significant from the perspective of providing a benchmark against which regulators will measure performance. Moreover, because the Report contains specific recommendations for regulators as well as market participants, it has increased the degree of regulatory focus in this area. In addition to the recommendation that regulators should clamp down on those with significant backlogs of unsigned trading documentation referred to above, the Report contains three recommendations for regulators. First, the Joint Forum recommends that supervisory authorities should undertake the steps necessary to enhance their understanding of evolving market developments in relation to credit risk transfer transactions. Secondly, supervisory authorities should periodically review regulations, supervisory guidance and reporting mechanisms that are pertinent to credit risk transfer transactions. Thirdly, supervisory authorities should continue efforts to share information on credit risk transfer activities with the objectives of strengthening their mutual understanding of developments, promoting further improvements in risk management practices by market participants and enhancing supervisory and regulatory approaches.

The recommendations to regulators are highly significant in that they put credit derivatives risk management firmly on the regulatory agenda and, from a UK regulatory perspective, one can expect the FSA to follow up on its findings and 'Dear CEO' letter in the not too distant future. Market participants will therefore need to take a good look at their risk management infrastructure to ensure that it is sufficiently robust not only to manage the risks but to withstand the scrutiny of an FSA review.

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This legal and regulatory round up is not intended to be a comprehensive guide to the subject matter it covers, or to provide legal advice. For further information, please contact Jonathan Marsh at Hunton & Williams: jmarsh@hunton.com

References and Notes

- 1 A cross-sectoral group combining the Basel Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).
- 2 The FSA's Senior Management Arrangements, Systems and Controls Sourcebook, SYSC 3.1.1.

- 3 *Interim Prudential Sourcebook*, IPRU (Bank-Chapter CD and IPRU (Investment Business), Appendix A63.
- 4 1992 ISDA Master Agreement, s9(e)(ii); 2002 ISDA Master Agreement, s9(e)(ii).
- 5 Principle 7 of the FSA's Statements of Principles for Approved Persons provides that an approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he/she is responsible in his/her controlled function complies with the relevant requirements and standards of the regulatory system. In its Code of Practice for Approved Persons, the FSA cites a failure to take reasonable steps to implement and oversee adequate systems of controls as an example of a failure to comply with Principle 7 (Code of Practice for Approved Persons (APER) 4.7.3).
- 6 See, for example, *The Group of Thirty Practices and Principles on Derivatives* 1993.
- 7 *Hazell v Hammersmith and Fulham London Borough Council* [1992] No 2 A.C. 122.
- 8 *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C 518,531 in which Mance J stated: 'The assumption on which most business is conducted is that both parties understand, or avail themselves of advice about, the area in which they are operating and the documentation which they use'.
- 9 See, for example, the 2002 ISDA Master Agreement Schedule, Part 4 para (m).
- 10 *Tournier v National Provincial & Union Bank of England* [1924] 1 K.B. 461.
- 11 Criminal Justice Act 1993, s52.
- 12 Those traded on UK recognised investment exchanges, OFEX and EEA regulated markets.
- 13 FSMA, s123.