HORIZON

from
SKADI

Martin Anthony
Business Development
Director
London

David Bridges
Product Development
Analyst
London

Damian Taylor
Product Development
Director
London

August 2022 Edition

HIGHLIGHTS

- Resumption of secondary-market trading in Russian sovereign and corporates bonds brings operational risks.
- Recent developments and requirements for firms and individuals to apply to the FRC register to be able to conduct Audits in the UK.
- August's 'Spotlight' feature, "Lessons from the last crisis" looks at valuation mechanisms underlying collateral agreements, and whether they may be fit for purpose.

CATEGORY OVERVIEW

Fraud headlines increased slightly in August from average levels, including a couple of stories regarding spoofing in commodities markets – a key focus of concern for regulators. Two former JPMorgan employees were convicted on charges of manipulating precious metals markets, and in Chicago an individual trader was fined USD 100,000 by the CFTC, in conjunction with the CME, for engaging in multiple instances of spoofing.

Audit news saw an uptick in headlines in August. The biggest story detailed China's National Audit Office review of the USD 3 trillion Trust Company industry that sits at the heart of its shadow banking sector to gauge the risks they pose to financial stability.

Figure 1: SKADI Sammendrag Articles by Category

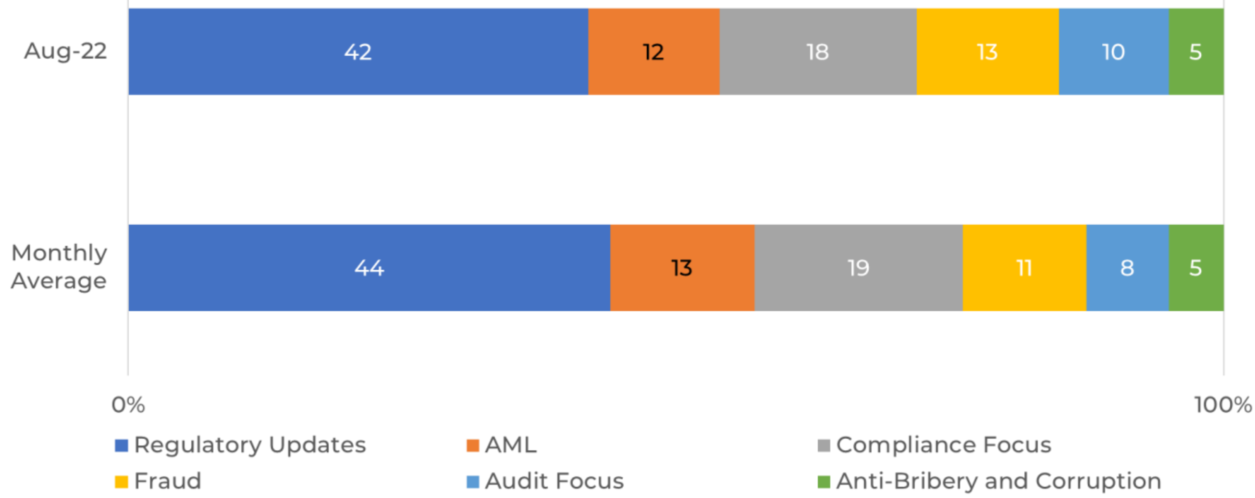
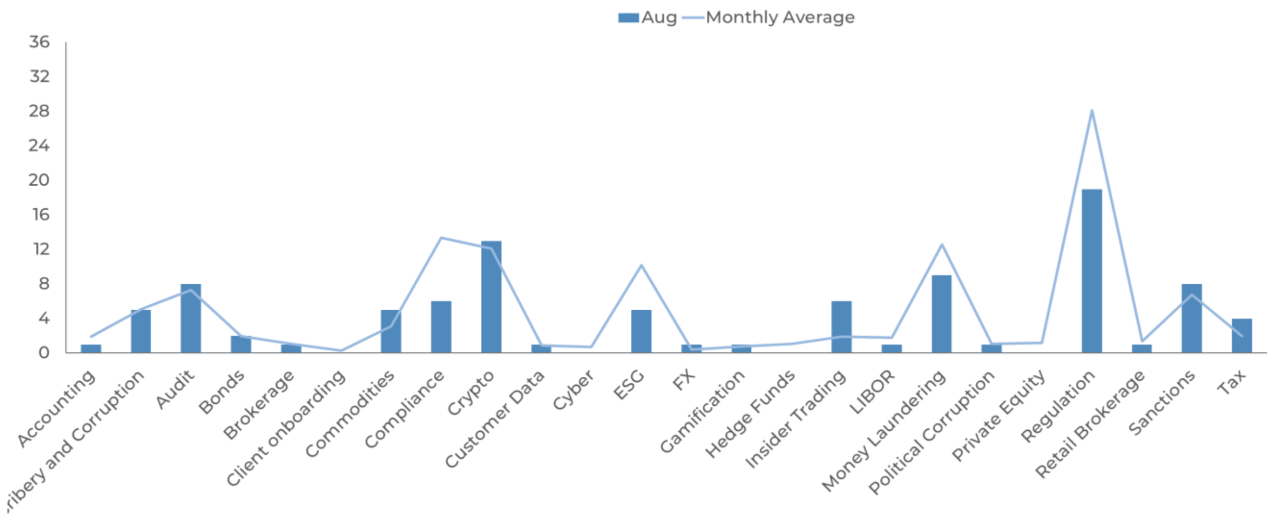


Figure 2: SKADI Sammendrag Articles by Topic



TOPIC DETAILS

Whilst ***Regulatory news*** topics softened from monthly averages, developments in the Russian debt space are noteworthy.

In June of this year, US investors were embargoed from trading in Russian securities as part of several sanctions against Russia (approximately half of USD 40 bln worth of Russian government bonds outstanding were held by foreign funds). In July, the US Treasury announced it would permit existing positions to be unwound and this month (August) we saw several Tier One Investment banks resume facilitation of client orders in Russian sovereign and corporate bonds.

Banks are challenged with helping clients unwind positions, whilst remaining compliant with current sanctions. A spokesperson for Jefferies explained they were "*working within global sanctions guidelines to facilitate our clients' needs to navigate this complicated situation*." BAML noted they were acting as "*riskless principal on client facilitation trades*". One source stated cases whereby documentation from clients prior to execution is required which would permit cancellation in the event of settlement failure.

This scenario creates several difficulties operationally, as explained by Dave Bridges, SKADI's operational SME. "*Strong controls will be imperative to detect any trades prevented from feeding downstream into settlement and accounting systems.*"

"If multiple client trades are due to settle on the same day, diligent inventory management will be crucial to prevent inventory settled from a larger purchase being utilised to deliver bonds on a smaller sell to a counterparty still waiting for a related purchase to settle. With the added risk of trade cancellations, an inventory position could inadvertently be created although traded positions would appear flat. If trades settle on a back-to-back basis, further vigilance will be required around settlement. Tight communication between front office, middle office and operations will be critical."

Additional Russian headlines detailed a decree signed by President Putin which bans investors from "unfriendly countries" from selling their holdings in energy and banking sectors until the end of this year. The decree encompasses nearly all financial and energy ventures which have large foreign holdings.

UK ***Audit*** headlines included details on the Financial Reporting Council's (FRC) announcement of a new register to control which firms are deemed as "fit and proper" to conduct audits of large listed companies, or financial institutions known as Public-Interest Entities (PIE's). Firms and individuals already auditing PIE's will need to apply for admittance to the FRC register by the December 5th deadline.

In July's edition of Horizon we discussed the record figure for UK audit fines levied by the FRC. In August, in an interview with the Financial Times, Sir Jon Thompson, the Chief Executive of the FRC, stated his stance on the situation clearly: *"It's no good complaining about the fines… the solution is entirely in [the audit firms'] hands. Do a good audit and you don't get in trouble with us."*

In other ***Audit*** headlines, the US-based Public Company Accounting Oversight Board (PCAOB) fined KPMG's Korean unit USD 350,000 under Section 105(c) of the Sarbanes-Oxley (SOX) Act "for failing to establish and implement appropriate quality control policies and procedures to protect against improper alterations of work papers". SOX enforcement fines appear to be on the increase (the PCAOB website details 7 so far this year versus only 5 between 2018 and 2021) – is this increase the start of a trend?

SPOTLIGHT: LESSONS FROM THE LAST CRISIS

Commentators are clear – the rise in power prices will likely lead to a rise in insolvencies. We would encourage Control staff at Financial Institutions to take proactive steps now to review and quantify the legal and documentation risk their institutions have in existing positions.

SKADI's experience following the Global Financial Crisis were that Valuation Mechanisms implemented in the case of bankruptcy on some contracts were not fit for purpose. This led to protracted disputes and complex valuation exercises. Consider the rate of innovation in the 15 years since the crisis. Risks include the multitude of different venues for pricing of securities, meaning the contractually specified one may no longer be the most, or even near to being the most, applicable one for the assets covered. Others may be in the channel of communication. SKADI's experience was that market participants had moved on to new channels of communication and no longer posted prices, or indeed had never posted prices, using the contractually specified communication channel – think Reuters screens…

Where lending agreements are backed by Eligible Collateral Schedules, Control functions should be focused on whether collateral is indeed "Eligible". Whether valuations are correct. Whether inputs to models are up to date after prolonged periods of low interest rates and relatively stable markets.

Complex trade reviews, asset quality reviews, as well as revisiting new product approvals and new transaction approvals would be worthwhile exercises in the months ahead.

HORIZON Takeaway Points for Audit and Control Teams

- As our Spotlight feature discusses, we would encourage Control staff to review and quantify legal and documentation risks in the current environment, especially with regard to collateral.

- One of our great concerns in this environment is the dependence that many models may have on recent data sets. We refer to this as "data recency bias". In the changing market environment, with interest rates and inflation pressures to the upside, we would recommend Control staff revisit modelling assumptions as a near term priority.

What is it we're doing here?

Released every morning, The SKADI Sammendrag covers headlines to assist Compliance, Internal Audit and control teams. In this monthly research document, HORIZON, we collate and analyse these 100 or so articles, finding themes and areas of focus for control functions.

SKADI

+44 (0) 20 7510 1762

enquiries@skadilimited.com

www.skadilimited.com

www.linkedin.com/company/skadi-limited/

https://www.youtube.com/channel/skadi-limited/