HORIZON

from

SKADI

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In this month's HORIZON:

- **CDS** – Credit Default Swaps are back! What could possibly go wrong….?
- **Record keeping** – Do this month's censures on record keeping signal a shift in regulatory attention?
- **SKADI explainer** – Following BoE CHAPS and RTGS technical issues in August – we take a closer look at these critical systems.

CDS

Single name Credit Default Swap (CDS) contracts are enjoying a resurgence. This reflects increasing concerns over the credit-worthiness of bond issuers, the challenges of hedging a portfolio with CDS indices, and the propensity for financial markets participants to have short memories.

A series of circumstances led to market participants gradually moving away from using single-name CDS. Up until the Global Financial Crisis negative basis opportunities, where the CDS trades tighter than the underlying bond in spread terms, were incredibly rare. As the Global Financial Crisis unfolded, negative basis opportunities began to be offered in abundance. Over the same period investors in search of tools to hedge exposure gradually began to utilise CDS that references credit indices. What investors lost in terms of correlation to their underlying portfolio was more than made up due to the increased liquidity compared with single-name contracts. The more cynically minded might also observe that negative basis is harder to see across a portfolio of bonds hedged with an index!

It would be a contract involving Hovnanian, a deeply indebted homebuilder, which finally turned the tide against single name CDS. In 2018 Hovnanian and a CDS holder entered into an agreement where Hovnanian would fail to make an interest payment on a bond the CDS holder would be insured against. Failing to make the interest payment would trigger a credit event, where CDS holders would receive a payment resulting from the technical default.

On the face of it, one might instantly call this out as a pre-arranged trade! But the arrangement was brought about as a result of a financing negotiation. Hovnanian entered into an agreement with GSO Capital Partners LP, who in return for Hovnanian failing to pay, guaranteed Hovnanian cheaper financing after the event. This was engineered by the issuance of two new Hovnanian bonds, which each carried a clause in their indentures prohibiting Hovnanian from making interest payments due on 2019 bonds held by a Hovnanian subsidiary – Sunrise - on the May 2018 interest payment date.

This placed a number of market participants at risk of losing money. Particularly those that had sold CDS contracts. They were further outraged by the fact that Hovnanian had funds to make the interest payment and was not in fact in a “dire financial position”.

The matter was settled between Blackstone, parent of GSO Capital, and Goldman Sachs, but the risk was recognised in the market that there could be other cases where issuers could be incentivised to miss payments in exchange for future funding benefits.

Now that single name CDS contracts are having another day in the sun, what are some of the things control staff should be on the lookout for?

Nicolas Corry, SKADI’s MD, points out:
“The arrangement between Hovnanian and GSO was cemented in a clause in the indentures of new issues Hovnanian planned to bring to market. We would encourage staff to be alert to the potential reputational damage that egregious undertakings, covenants and clauses could have when written in issuance contracts. We see this as being at greatest risk and prevalence on desks involved in restructuring, and those advising and offering private financing. But it is also worth considering the risk for new issues brought via the public market.”

Control Staff involved in price testing should be alert to the integrity of CDS pricing, and where traders are marking CDS in their books. Whilst negative basis can exist from time to time, it is not the norm. It is also a sign of the market experiencing stress. A number of internal desks and customers are often price takers from desks that have the responsibility of marking CDS contracts. Where CDS contracts are marked incorrectly, particularly in contracts where the desk is not prepared to transact on the marked price, then friction can ensue. This can lead to increased customer complaints, friction between staff, and, at worst, can lead to rises in whistleblowing and disputes.

The other area we would encourage Control Staff to revisit are the static set up of contracts, ensuring that contracts are feeding correctly. With the re-introduction of any instrument there is the raised risk of systems picking up stale feeds, or contracts being incorrectly set up by staff who are lacking in experience or who’s knowledge is “rusty” on products.

Record keeping

Record-keeping fines continued to prevail in August. The SEC and CFTC made further fines around the use of WhatsApp messaging totalling US$549m during the month. OFGEM, the UK’s energy regulator, fined Morgan Stanley’s energy trading function for discussing energy trades over WhatsApp on privately owned phones. The fine of £5.41m was lower than those previously levied by financial regulators, but marked the first fine relating to wholesale energy products in the UK where a firm has failed to record messages.

A fine levied on Citigroup Global Markets (Citi) by the SEC during August, gave a reminder that there are other forms of record keeping (or lack of!) that can

result in regulatory attention. The charge was made for "*violating recordkeeping requirements concerning expenses that the firm incurred in connection with its underwriting business*."

When a primary issuance is arranged, a lead manager will be appointed as the "Billing and Delivery Bank" (BDB). In addition to settling primary orders to participants, they calculate pro-rata underwriting fees to be paid to each syndicate lead manager.

Like other lead managers when acting as BDB, Citi levied direct and indirect expenses to the syndicate. Whilst charging indirect expenses was not unusual, the calculation basis Citi employed was particularly prescriptive, with staff even using an "allocation grid" to facilitate the process.

Indirect expenses were calculated as a fixed percentage of the deal's underwriting fee. For equity offerings, 7% of the underwriting fee was calculated, with a cap on the indirect cost at either $75,000 or $85,000 dependant on the underwriting fee. Debt issuances calculated indirect expenses as 10% of the underwriting fee with a cap of $75,000.

Total indirect costs for each issuance were then subject to the aforementioned "allocation grid", which apportioned expenses into different cost categories. Some cost categories look more "indirect" than others. Some we would argue looked rather "direct"! Categories included annual subscriptions to market data vendors, word processing, copying, printing, travel and entertainment.

The SEC ruled that Citi, in their capacity as a securities underwriter, calculated expenses for underwriting for at least ten years up to May 2019 and *"did not know the basis for its method of calculation of indirect expenses during the relevant period, including its use of fixed percentages of underwriting fees to calculate indirect expenses per deal"*.

The regulator discovered the bank had no policies or procedures for estimation and accounting of their indirect expenses for underwriting each deal. Steps hadn't been taken to review or verify the reasonableness of their methodology.

We feel that this is not necessarily an isolated case. From our own experience there are other instances where charges are levied on or by trading desks which are not backed up with policies or procedures justifying how they are arrived at. Areas that Control Staff should focus their attention on are those impacting external parties, such as on billing and delivering. But also, where charges and costs are allocated out on pools of customers and counterparties without stripping out identifiable direct costs, and where remaining cost allocations are not backed up by defendable ad hoc processes.

Damian Taylor, a SKADI trading expert, observes:
"Such practices are not confined to external counterparties. Treasury, Finance and Operations are some of the functions that have the ability (and need) to allocate costs to internal desks, that can cause friction when affected desks do not agree or understand the rationale for the charges and costs being levied against them."

SKADI explainer CHAPS and RTGS

On the morning of 14th August, the Bank of England's CHAPS and RTGS systems experienced a technical issue, putting them offline for a number of hours. The issue was resolved by midday. What is the impact of this from a Wholesale markets perspective?

David Bridges, SKADI's Operations expert explains:
"*CHAPS is operated by the Bank of England. The payment system is used for high-value time-critical sterling transfers in Wholesale markets and also used in the retail space for high-value transfers such as buying property*.

Whilst CHAPS payments only accounts for 0.5% of the UK's payment volume, the transactions made through CHAPS make up 92% of total GBP payments by value. On average £344bn is transferred each day over the system.

What about RTGS? This is the Bank of England's accounting system that sits behind sterling payment transfers. Permitted institutions hold settlement accounts within RTGS. Funds held in such accounts settle obligations in several UK payment and securities settlement systems.

Although RTGS settles an array of UK payment systems including Faster Payment and BACS, the vast majority of the value of transactions within RTGS comes from CHAPS payments or CREST DVP (Delivery vs Payment) activity.

RTGS provides CHAPS direct-settling participants with embedded CHAPS settlement within CREST. The LCH (London Clearing House), who settle a large percentage of centrally cleared OTC derivatives, and Euroclear are both CHAPS direct participants.

With a 2:55PM cut off for Gilts and Equities (DVP) for settlement at CREST, the pressure would have been on for settlements teams playing catch-up due to the delay, together with funding, cash management and payment screening functions."

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