HORIZON
from
SKADI

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- **Independent price source reviews** – post Bloomberg/SEC settlement
- **Documentation review** – a check on "fall-back" provisioning with USD LIBOR cessation on the horizon end June 2023
- **Russian sanctions** – a blocked shareholder vote, and replacement bonds

The month in review

January saw the publication of an LCH RepoClear report reviewing the recent volatility in the UK gilt market and "highlighting the repo market's need for central counterparty stability, predictability and resilience". This returns to a theme we have reported on in previous Horizons (see our July and November editions). The report details "many repo market participants, including pension funds, are actively reviewing their toolbox of execution options – including cleared repo."

Pension funds that employed LDI strategies were put under extreme pressure in the gilt sell-off in September 2022, selling positions to fund margin calls and settling gilts and gilt repo, both of which usually trade on a T+1 basis.

The SKADI Sammendrag picked up two interesting stories regarding Russian sanctions in January. First, the Amsterdam court of appeal's decision barring a shareholder affiliated to a Russian bank from voting at Croatian food producer Fortenova's shareholders meeting. Sberbank Rossii PAO was already subject to sanctions, whilst SBK ART, which held the position on their behalf, was added to EU sanctions in December.

Secondly, whilst Russian Eurobonds continue to be blocked from receiving payments due to sanctions, Russia's central bank made a recommendation for retail investors to convert their foreign currency Eurobonds into local "replacement bonds". Replacement bonds are denominated in foreign currencies, but repaid in Roubles, and have already been adopted by both Gazprom and Lukoil, amongst other major Russian issuers. Retail investors account for 20% of the holdings frozen by Western sanctions, worth USD81 billion.

As Dave Bridges, SKADI operations advisory SME, notes...

"Settlement, asset servicing and control functions should remain aware of these developments in the repo, proxy voting and corporate action space. Once again, the knock-on effect from the gilt market volatility and Russian sanctions continue to create challenges for control functions."

Forward-Looking

In January, the SEC settled charges against Bloomberg for "misleading disclosures about its valuation methodologies for fixed income securities." The issue was regarding Bloomberg's BVAL subscription service, which was found to allow certain fixed income securities to be valued based off a single data point, such as a broker quote. This did not adhere to the methodologies Bloomberg had disclosed, and could have meant that there was potential for mis-marking of illiquid positions. The SEC, in its settlement, referenced a violation of the Securities Act section 17(a)(2) which imposes liability "on anyone who directly or indirectly obtains money or property by means of a misrepresentation or omission..."

This brings up two points for control functions consideration that we have spoken about in previous Horizons...

First - checking that valuation methodology uses more than one data source, and then reviewing the methodologies used by that data source. Bloomberg is, quite rightly, seen as a "gold standard" with regards to pricing, but as the above settlement shows, even they can trip up regarding illiquid securities. Marking should always require more than one independent pricing validator.

Second - a review of documentation and wording around "fall-back" valuation methodology, especially in the case of bankruptcy. With the speed of innovation we have seen in the past 15 years since the financial crisis, and the multitude of different venues for trading and pricing instruments, there is a possibility that the contractually specified fall-back valuation methods (Reuters screen anyone...) may no longer be applicable. This could come to the fore in the next few months, with USD LIBOR set to cease, although a synthetic version will continue for some time. Most issues around this will be covered by an automatic fall-back in "tough legacy" contracts, and a "safe harbour" for eligible persons who select SOFR (Secured Overnight Financing Rate) as a replacement, but we would recommend control staff review and quantify legal and documentation risk from a valuation/ "fall-back" standpoint.