HORIZON

from SKADI

Damian Taylor

Nicolas Corry

October 2022 Edition

- No one puts Junior in the corner… NY Supreme Court case regarding amendment of the "no-action" clause in bond documentation.
- Rho, rho, rho your boat… a look at interest rate hedging.
- Taxing times… threat of uptick in fraudster "low taxation schemes".

The month in review

"risks in shadow banking"

Market volatility remained elevated in October, but the 35th anniversary of the 1987 Crash passed without a repeat performance (much to the annoyance of headline writers).

An opinion piece in the FT, "*Asset Managers may regret becoming the new banks*" looks at risks that may have built up in the markets away from the heavily regulated banks. As the author concludes, and we wholeheartedly endorse, "… most private credit managers have no experience with the defaults and write-downs that can accompany a prolonged recession. Regulators and investors should stay alert."

With some semblance of normality (we'll see how long that lasts!) returning to the UK, the prospect of tax rises once again comes to the fore – a topic we raised back in July. Whether the funds come from expanding a windfall tax on energy producers, or a levy on the banks, there is no doubt that any documentation around tax-efficient products should be reviewed by control teams promptly.

Finally, a ruling by the NY Supreme Court in October shone a light on an area where SKADI has a wealth of expertise – the position of various creditors in the capital stack. As the FT reported at month end, during 2020 several PE-backed companies raised emergency capital by "…allowing a subset of existing lenders to jump ahead of other lenders in claiming collateral in exchange for the fresh cash".

Bond/loan documentation will normally contain a so-called "no-action" clause that governs when a creditor is allowed to take enforcement action against the issuer. The Court ruled that the no-action clause was amended in bad faith at the time, and has been described by various commentators as "creditor-on-creditor violence".

"junior bondholders' position in the capital structure after amendment to "no-action" clauses"

SKADI

"review of bond documentation"

For more details on the case see *here* and *here*, but it does once again bring up one of SKADI's favourite areas for Control functions, and one that we have forewarned of in many of the past editions of Horizon - the case for reviewing of bond documentation, especially with regard to positions within the capital stack in case of default/ restructuring.

Forward-Looking

Rho hedging

One of the products that the SKADI team has first-hand experience of is Convertible Bonds (CBs). Trading the Asian region is a nuanced affair. There are structural reasons for this. Many of the risks embedded in the product are un-hedgeable in Asian markets outside of Japan. Hedging of the underlying equity is tricky - often short-selling is not permitted in some markets. There is a lack of stock borrow or a restrictive market in others. From a credit standpoint, hedging is also difficult – the infrequency of asset swap bids, or illiquidity in the CDS market. In the case of equity and credit there are index products available but these bring with them the challenges of correlation risk. Often the companies choosing to raise finance via Convertible Bonds are smaller than those that would be found in the indices with related futures contracts. These combined factors lead to a market that is often traded on an unhedged, or outright, basis. The idea that Asia is an un-hedgeable market pervades into the one risk factor that can be hedged - interest rate risk, or Rho. Whilst there are Interest Rate Swap and Futures markets available for traders to utilise, many do not hedge their books.

As Nic Corry, CEO of SKADI explains:

> *"…when interest rates are stable, or falling, this does not present a problem. Indeed, a falling rate environment serves to support the skew found in Asian CBs, enabling traders to cheapen bonds to the upside. In a raising rate environment, however, movements become more problematic. We are now at a point in the cycle where traders with unhedged books are at maximum "FOLI" – Fear Of Locking In! The dilemma is whether to initiate hedges now, or wait in the hope that rates recede. The immediate risk from a control perspective is that traders could take steps to misrepresent their risk. This is either through directly mismarking their positions, or by altering the static data inputs to adjust the Rho exposure (and related measures) reported through the institution's risk systems."*

"FOLI" – the new FOMO!

"could traders take steps to misrepresent their risk?"

A wide range of traded products beside Convertible Bonds have embedded interest rate risk. We advise Control functions to revisit Independent Price Verification processes and to look carefully at whether controls around contributions to systems such as Totem are robust. Ultimately the marking from traders' books feeds through to customer valuations leaving institutions vulnerable to customer complaints or worse…

"revisit Independent Price Verification processes"

Collateral thoughts

According to the FT, 20% of fixed-rate mortgages are due for refinancing in the next year. With such a potentially large jump in rates, will people be able to afford it, or will they be forced to sell or default?

"danger of position mismarking in current environment"

Damian Taylor, Director at SKADI:

> *"It would be interesting to understand what percentage of defaults are factored into any mortgage-back products (RMBS, CLO etc..) owned or structured by the bank. Have these been adjusted higher for the current environment? How often are these reviewed (monthly, quarterly, annually)? Could there be potential for mismarking? All of these questions should be at the forefront of control staff's thinking."*

Yield to tax

The growth in fraudulent schemes over the past decade (and amplified during the pandemic) which targeted the large cash sums held by individuals and corporations preyed upon their need for yield in the accompanying low-interest rate environment. Fraudsters used cryptocurrency, ESG, and other flavour-of-the-moment trends as hooks.

"fraudsters and the "low taxation scheme" lever"

As rates have increased, and they have increased dramatically, there is less incentive to pursue schemes involving such complex products. As governments around the globe, the UK being a prominent example, seek to plug significant budget gaps, the prospect of raised taxes is presenting itself. Control staff should be alive to the threat of fraudsters seeking to use the "low taxation scheme" lever to dupe customers, in particular, the less sophisticated ones, that entering into certain schemes and products could legitimately shelter them from higher taxes.

SKADI

+44 (0) 20 7510 1762

enquiries@skadilimited.com

www.skadilimited.com