SKADI Impact Piece

A ~~Comedy~~ Tragedy of Errors

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Skadi Scores: Risk Focus

Payments Processing	Low	Med	**High**
Transaction Approval	Low	**Med**	High
Legal Documentation	Low	Med	**High**
Approval Committees	Low	**Med**	High
Bootstrapping Systems	Low	Med	**High**

Summary

A look at recent payment errors and the control processes around them.

Introduction

Last month's press highlighted an error regarding a coupon payment on a hybrid bond issued by UniCredit. This is the latest in a series of payment errors that draws attention to the need to revisit some of the control processes around the movement of cash in and out of financial institutions and highlights just how many of the processes "under the hood" in financial institutions still rely on manual intervention. In this research piece, we will also take the opportunity of looking at a recent slew of typo errors in product documentation and the reputational risks that they can bring.

Sorry We Misplaced the Decimal Point, Iberdrola Tells Investors (Source: Bloomberg, May 2021)

Citigroup Misstated Maturity Date on $1 Billion Bond by 18 Years (Source: Bloomberg, September 2020)

CRYPTOCURRENCY COMPANY BLOCKFI ACCIDENTALLY SENDS USERS MILLIONS IN BITCOIN – AND NOW IT WANTS IT BACK
One user received 700 bitcoin – worth £21m – rather than $700
(Source: The Independent, May 2021)

UniCredit Bondholders Say They Got Coupon Bank Vowed to Skip (Source: Bloomberg, May 2021)

Citi loses its bid to reclaim cash from a $900 million mistake.
(Source: New York Times, February 2021)

Hedge Fund Bondholders Sue Aristocrat Leisure for Failure to Convert Bonds On Demand; Federal Court Limits Evidence to be Presented at Trial
(Source: Hedge Fund Law Report, October 2009)

A UniCredit coupon that they decided would not be paid was still credited to some bondholders by Euroclear.

Background

UniCredit's new CEO announced that the bank would not be paying the coupon on its CASHES Dec-2050 (Convertible and Subordinated Hybrid Equity-Linked Securities), scheduled for payment 25-May-21. The coupon payments on these bonds are linked to the profitability of the bank and so this was permissible under the CASHES terms. UniCredit had been loss making in 2020, but to complicate matters further the bank had previously stated on an earnings call earlier this year that the coupon payment would be honoured.

Euroclear "internal processing error" credited certain accounts.

The issue was not around the backtracking of this payment, but the fact that a number of accounts were credited for the amount of the coupon by Euroclear even after UniCredit had cancelled the payment. Euroclear says that no cash payments were made because of the "internal processing error" and that it was only credits that appeared in accounts and that they were blocked until confirmed as final. However, there was ample time for the coupon payment to be cancelled as Euroclear advised that the payment would not be made 19-May, but some bondholders still received payments on the 25-May.

Citibank encountered a payment error back in 2020 with regard to a Revlon loan.

BlockFi paid out BTC in error instead of USD.

Similar Recent Payment Errors

The error has resonance with the problems encountered by Citibank recently regarding a Revlon loan payment to various hedge funds that occurred in August 2020 (and that we have previously written about) and also the recent BlockFi mis-payment of Bitcoin (BTC) rather than US Dollars (USD) to client wallets as part of a promotion. The BlockFi error shows that even cutting-edge financial innovators are subject to the problems of human operator error. We are having to make an assumption that this was human error here as it is hard to find much information on what happened but given the nature of Bitcoin and its finite supply, an institution is unable to "create" Bitcoin out of thin air to send to someone (you would run into a double-spend issue and there would be a break in the blockchain).

Hedge Funds still retain $500m of the loan principle after a NY court ruled the payment should stand.

Example 1, Citi/Revlon: In August 2020 Citibank, acting as Administrative Agent for a loan taken out by Revlon, intended to wire an interest payment of $7.8 million to a group of Hedge Funds but, due to an "*operational mistake*", erroneously wired almost $900 million of its own money instead. Half of the money was returned by the hedge fund recipients, but the other half was kept and is, at time of writing, still with the hedge funds who have successfully challenged the need to repay in court, citing the "discharge-for-value" defence. *[We have written in greater detail on this case, see Skadi Impact Piece 19-Feb-21]*

BlockFi credited 1 account 700 Bitcoin rather than USD (around $28m worth).

Example 2, BlockFi: In May 2021 BlockFi, as part of a promotion that they had been running, mistakenly sent Bitcoin instead of USD to a handful of their customers. One customer was sent 700 BTC (equivalent to around USD28m at the time) rather than 700 USD. BlockFi claims to have recouped the bulk of the mis-payment and said that its current exposure is "less that USD10m", although given the current unregulated structure of the crypto market this is hard to verify.

Somewhere along the payment chain a manual process or override has caused the problem.

Internal Decision Making

It is probable that UniCredit would have had to put the decision to not pay the coupon before internal approval committees. One imagines the Reputational Risk Committee and perhaps a Transactional Approval Committee. Despite these checks, and all the commensurate internal paperwork that the decision would have generated, the payment error occurred because of a manual process. Euroclear claims that some bondholders were credited in their accounts, but that no actual money was transferred. It is unlikely that Euroclear would release any funds without having received them from the underlying counterparty, so we have to surmise that UniCredit had submitted funds to Euroclear. Therefore, somewhere along the payment chain, a manual process or over-ride caused the problem, or perhaps Unicredit forgot to cancel the payment in their system and only realised the coupon had not been rescinded until it was party paid out

Still, in 2021, some very high-risk areas of finance rely on manual processes.

The mis-payment issues highlight that even though finance presents an image of being a cutting-edge technology driven business, the reality is that some very high-risk areas of finance, still, in 2021, rely on manual processes.

Not enough thought is given to the systems implications.

Control Oversight of Manual Process

As both the UniCredit and Citi/Revlon examples show, it is crucial to understand how fully signed-off, internally checked decisions are implemented, and what the internal systems implications of these decisions might be. We do not have oversight on what happened regarding UniCredit (maybe the payment was already set up in the systems and a manual over-ride was needed to stop it) but we do have greater clarity in the Citi/Revlon case due to the court documents. In this case, even though internal procedures were followed to the letter, certain system warnings were over-ridden, and funds that were supposed to wash through an internal account were sent out of the bank in error.

Payment processing often run from overseas offices.

Payment processing is often outsourced or run from offices overseas, and these offices can have a high turnover of staff. Rather than understand the rationale behind a process, work is processed by a flow diagram. If the outsource provider is releasing the payments (as in Citi/Revlon), even with the best oversight and controls, by the time London or New York are alerted, it is already too late. From our experience, additional controls around all of this only tend to be put in place after 2 scenarios:

a) a major error like Citi/Revlon, which will lead to a big internal post-mortem
b) Internal / external audit pull everything apart, and controls are tightened to close audit point

In any case, the owner of the process - usually an operations manager in London or NY, do not want either a) or b) to happen, and need to be able to stand behind the controls, procedures and governance over the outsourcer.

Typo errors in financial documents can have major reputational and financial consequences.

Errors in Investment Offering Memoranda

The financial press has also highlighted a recent instance of an error in product documentation regarding an Iberdrola bond and a misplaced decimal point on an interest rate payment (see below). Errors in documentation can have minor consequences, although do always come with reputational risk. Some errors, especially if they make their way into Indenture documentation, can have profound implications for both the underlying company and the financial institution(s) that arrange them.

Iberdrola loan EURIBOR +65%, not 0.65%.

Example 3, Iberdrola: Eagle eyed investors might have spotted the typo in the term sheet of a floating rate note issued by the utility company in April 2021. An interest payment of "3-month EURIBOR + 65.00 per cent" was amended before any damage was done to the correct "3-month EURIBOR + 0.65 per cent".

Citi adds 18 years to a bond maturity date.

Example 4, Citigroup: Made a mistake when drawing up a bond prospectus in 2013. The document was headed "6.675% Subordinated Notes due 2043," but its maturity was given as 13-Sep-2025 at 3 different locations in the text (it happened to also be selling some subordinated bond maturing in 2025 at the time). The error was corrected in 2020 when Citi sent out an amendment confirming the 2043 maturity date.

Aristocrat Leisure documentation quotes USDAUD rather than AUDUSD

Example 5, Aristocrat Leisure: In 2004, Aristocrat Leisure launched a suit to seeking a declaratory judgement to correct a "scrivener's error" in the initial indenture of a Convertible Bond they had launched in 2001. The error mistakenly read "A$0.514 = US$1.00" rather than "US$0.514 = A$1.00". A further parallel with the Unicredit decision discussed earlier, is that there was a change in Aristocrat Leisure Management, and when the incoming management noticed the error they made an attempt to call the bonds, and argued that this reversal of rate nullified the holders right to convert.

Cineworld 1% LIBOR floor rather than 0%

Example 6, Cineworld: In 2021 a drafting error in the final credit agreement of a rescue loan included a clause in the interest expense of a "1% Libor floor", even though Cineworld intended it to be 0% floor. They initially refused to pay the 1% loan amount owed, although capitulated when they were informed that the lenders would freeze access to the loan as it was in default.

Terra Firma mistakenly pledged assets.

Example 7, Terra Firma: In 2016, an error by a law firm in the drafting of bond security documents led to a group of 24 care homes being mistakenly pledged to Four Seasons care home's lenders. The High Court ruled that a "serious error" had occurred in the drafting of the documents and that they could be re-written to exclude them.

Documentation Terminology

Before we go into more detail on the issues regarding typographical errors (in legal parlance, a scrivener error) in product documentation, it is important to understand the differences between the 3 main document types.

- A <u>Term Sheet</u> is an equivalent to the executive summary of a product. It is a non-binding agreement that details the basic terms and conditions of an investment and is released just as the product comes to market.

- A <u>Prospectus</u> is a much more detailed summary of the terms and can run to several hundred pages. It is a formal and legal document that contains details about the structure and goals of the issuer.

- An <u>Indenture</u> is the legal documentation that is referred to if there is a conflict between issuers and holders. As shown in the Aristocrat Leisure case above, the fact that an error due to the inverse nature of the Australian Dollar quote was present in the final document led to multiple expensive court cases.

Copy-and-Paste Job

Most documents generated from templates – all must be double and triple checked.

New issuance – either feast or famine.

A lot of investment documentation is based off "copy-and-paste" templates that then have issue-specific terms added. Whilst all documentation will be checked countless times by corporate finance and legal teams, there will be a small number of cases where something slips through the net. It is key to note that issuance is not a "smooth" process that happens at regular intervals over a year - it happens in slews because issuance is so sensitive to market conditions. You might have months where nothing happens, and then suddenly there will be a bonanza of issuance, and suddenly multiple issues are on-going at the same time. The risk of document mistakes are therefore much higher as corporate finance and legal departments will be working all hours to get documentation prepared.

The Tombstone

Reputation risk wherever you appear in documentation.

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While some corporate issues may only have 1 or 2 lead managers, there will be any number of larger issues where banks big and small are pitching to get in on the act, whether in a large underwriting capacity, or in a much smaller placing capacity. It is key to note, wherever your position is on that front page of the document (generally referred to as "The Tombstone"), there is no place where you do not have reputational risk.

Institutions need to be fully aware of reputational and financial risks.

Conclusion

In this Impact Piece we have discussed the risks associated with errors due to either the internal processing of payments, or due to mistakes in drafting of product documentation. In both cases it is beholden on financial institutions to be fully aware of the financial and reputational risks that can occur because of these.

Key to understand the manual processing implication of decisions.

From a review perspective, it is imperative to have a full understanding of how much manual processing is going to result from an internal decision. A change to a payment schedule, or the addition or removal of financial clauses may be easy to sign-off and document (hopefully without any typos!), but due consideration must always be given to how this is to be implemented in practice from a systems perspective.

Prevention better than the cure!

Controls only tend to get strengthened after a major error and by that time it is too late. It is a case of prevention being better than the cure.

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