

# Scottish Financial Services

## Credit Crunch

Tuesday, 22 April 2008

# Credit crunch 2008

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## Looking at

- ▶ Climate change
- ▶ Run on the Rock
- ▶ How it impacts firms
- ▶ A hot topic – hedge funds
- ▶ Another – market abuse & fraud
- ▶ Disputes – avoiding & managing

# Climate change

# Climate change

- ▶ The new “less benign” economic environment
  - Business models under strain
  - Eye off the regulatory ball
  - Increased risk of financial crime
  - Financially pressured consumers
- ▶ And a smarter regulator

## And this calls for

- ▶ Stress testing for sustainability
  - Business models
  - Products
  - Funding plans
- ▶ Reviewing risk
  - How has it changed for you?
  - Assessment
  - Management

## Risk management in market turbulence

- ▶ Effective firm-wide risk identification & analysis
  - Share information
  - Challenge
  - Action firm-wide
- ▶ Independent & rigorous valuation practices
  - Need to develop expertise in-house
- ▶ Effective balance sheet management
  - Align treasury with risk
  - Incentivise business to control activities
  - Identify contingent risks

## And also ...

- ▶ Flexible risk measurement & management reporting
- ▶ Role of senior management in achieving this
- ▶ Risk management function
  - Senior
  - Supported
  - Firm-wide
  - Access all areas
  - Flexible & informed



## Some specific areas for review

- ▶ Wholesale
  - Positions & valuations
  - Remuneration policy
  - Market abuse

▀ Retail

- Financial promotions
- Disclosure
- Treating customers fairly

# The Run on the Rock

## “Run on the Rock”

- ▶ Directors “reckless”
  - 20% annual growth
  - Prudent lending but
  - 75% wholesale funding annually renewed
  - Diversified but not foresee all markets close

## Looking back – what went wrong?

- ▶ The bank that time forgot
  - ARROW visit with no RMP
  - Close & continuous that was neither
  - One visit in two year period
  - No proper records kept
  - No elementary grasp of NR risk profile

- ▶ Why?
  - Management weakness
  - Clear no controls
  - How widespread?
- ▶ Did it make a difference
  - Could it have been spotted?
  - How would management have responded?
- ▶ Atypical
  - How do we know?

## Looking forward – better next time

- ▶ Changing some international agreements
- ▶ Enhancing the Tripartite arrangements
- ▶ Speeding handling an insolvent bank
  - Issues here
- ▶ Enhancing the compensation scheme
  - Issues here

## What this means for firms

- ▶ Fundamental regulatory approach unchanged
- ▶ Supervision to get greater resources
- ▶ More demanding engagement
  - Capital
  - Liquidity
  - New plans
  - Management skills



## Especially on the capital front

- ▶ Pillar 1 = minimum for credit, market & operational risk
- ▶ Pillar 2 = capital for risks
  - Firm assessed by ICAAP (ARROW aligned)
  - FSA challenges by SREP
  - And issues ICG
    - Governance
    - Risk management
    - Oversight
    - Controls

# Key Risks in Turbulent Times

Alison McHaffie

## Key Risks

- ▶ Alternative Investment Managers – a particular focus
- ▶ Market Abuse & Fraud – a growing threat
- ▶ Disputes – avoiding and handling

# Hedge Funds

# Hedge Funds – are they at the sharp end?

- ▶ “Hedge Funds are not the catalyst or the drivers of the current financial turmoil”
- ▶ FSA is not looking to change its regulatory approach
- ▶ 6 month surveys of prime brokerage exposures
- ▶ Relationship manage 35 largest HFMs

## Current issues for Hedge Fund Managers

- ▶ Market Stability –focus on interaction between banks and their hedge fund counterparties
- ▶ Market integrity – Market Watch 24
- ▶ Market quality – CFDs and disclosure of voting rights, side letters
- ▶ Robust systems and controls particularly in valuations
- ▶ Recent publications of codes and guides – IOSCO, AIMA, Hedge Fund Working Group

# Market Abuse

## Market Abuse

- ▶ Turmoil – gives the opportunity and incentive for rumours and market abuse eg HBOS and Soc Gen
- ▶ Market cleanliness study
- ▶ FSA “determined to use all avenues, powers and tools available to it, and expects to present a tougher all round edge”



## What does this mean for Firms?

- ▶ Enhanced transaction surveillance – Sabre 2 system
- ▶ Thematic Visits
- ▶ Floor Calls
- ▶ Increased number of investigations and enforcement actions and criminal prosecutions
- ▶ New telephone taping rules and increase in FSA requests for this material
- ▶ Specified Prosecutor – ability to offer immunity from prosecution

# How to Avoid

- Review systems and controls
- Regular staff training and advise how to deal with FSA floor calls
- Personal account dealing rules and stop lists
- Effective supervision of staff
- Document reasons for dealing on information
- Monitor trades to ensure identification of anything unusual
- Trading mandates
- Ensure suspicious activity escalated to senior management and acted upon
- Take note of FSA publications eg Market Watch 24 and 25

## What to do?

- If firm discovers, identify scale of issue and make suspicious transaction report to FSA
- Consider if any remedial action required
- Take legal advice and arrange legal representation for key staff
- Implement document retention policy
- Internal investigation to identify and rectify any failings in controls

# Disputes

## An Increase in Disputes?

- ▶ Investors look to recoup losses from deep pockets
- ▶ Potential knock on effects of US litigation
- ▶ Leading UK fund management case – Unilever v Mercury Asset Management

## What claims might be brought?

- Underperformance not grounds for a claim
- Usually for breach of the contractual duty of care and skill and the concurrent duty in tort
- The required duty is that of an ordinary skilled person with the same investment expertise
- Mismanagement – eg breach of investment mandate or negligent management in failing to take account of risks
- Misrepresentation of the risks in promotional material
- Misvaluation – negligent valuation of assets to the detriment of investors

## Avoiding Claims

- 1. Comprehensive information to investors
- 2. Careful drafting of investment management agreements and regular review
- 3. Identifying underperformance, communicating and remedying
- 4. Robust and effective compliance systems and controls
- 5. Effective supervision and monitoring of staff
- 6. Documented reasons for dealing
- 7. Document retention and destruction policies
- 8. Recognition and effective management of conflicts
- 9. Effective anti fraud measures
- 10. Seeking legal advice early

## Handling Claims

- ▶ 1. Indemnity Insurance notification?
- ▶ 2. FSA notification – Principle 11?
- ▶ 3. Internal investigation to assess the strength of the claim
- ▶ 4. Consider obtaining early expert advice
- ▶ 5. Consider alternative dispute resolution options
- ▶ 6. Retain documents, suspend any destruction policies



# Regulatory Consequences

## Regulatory Implications

- ▶ Regulatory obligation to cooperate with FSA
- ▶ Risk of disclosure in civil proceedings – *Real Estate Opportunities v AAM & others*
- ▶ Privilege
- ▶ Confidentiality under s348 FSMA

## How to mitigate regulatory risks

- Identify scope of investigation
- Consider separate representation for key staff
- Careful drafting of letters to FSA
- Consider limiting material received from FSA
- Use privilege as a protection where possible

## Other potential claims

- ▶ Claims by institutional investors against the credit rating agencies – negligent misstatement
- ▶ Claims by borrowers that they were missold loans
- ▶ Fraud claims eg Barclays v Bear Stearns in US
- ▶ Employee litigation generally increases in a downturn

## Conclusion

- ▶ Continued regulatory focus on market stability and market integrity issues
- ▶ An increase in market abuse investigations and some significant fines/prosecutions
- ▶ An increase in claims being made against firms

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