

## **An examination of the current trends surrounding UK Credit Market Regulation**

The recent precipitate reduction in credit market liquidity has lead commentators in the UK to call for more regulation. The finger has been pointed variously to (i) requirements for more disclosure of credit derivative holdings; (ii) reform of accounting standards and regulatory reporting requirements; and (iii) regulation of rating agencies. In the UK, following the travails of the Northern Rock Building Society, there has also been debate about the effectiveness of regulatory supervision. The effectiveness of a tripartite regulatory structure constituted by the FSA, the Bank of England and the Treasury to respond to a banking crisis has been put under scrutiny. The burden of this note is concerned with the former matter of the scope and content of regulation of the credit markets rather than the closely related matter of how this regulatory regime is supervised and operated.

The extensive use by banks of credit derivatives and securitisations has reduced transparency of the location and concentration of credit risk and has not fully insulated financial institutions from credit default liabilities and losses. However, regulation of banks and investment businesses in the UK which are active in the credit markets requires the maintenance of adequate financial resources with proper regard to prudential risks such as liquidity, credit and securitisation risks. In addition institutions that have securities listed on an EEA exchange are subject to ongoing financial disclosure requirements. There may be lacunae in regulation in relation to offshore securitisation special purpose vehicles ("SPVs") and credit rating agencies but it is contended in this [article] that the focus of regulation should remain upon regulated banks and investment businesses acting in full compliance with existing risk management and disclosure rules and not upon the introduction of new regulations.

### **Background**

There are a number of reasons for the recent fall in credit market liquidity in the US and European credit markets which must include the inevitable course of a credit cycle inherent in the operation

of normal market forces. The FSA had been warning the credit markets in general terms from at least January 2007 of concerns about tightening in global credit markets and the risks of a reduction in financial liquidity. Nonetheless, significant contributing factors to the unexpected scale and rapidity of liquidity reduction experienced have been the growth of credit derivative products and the widespread use by banks of asset securitisations using SPVs.

The acquisition of debt assets and their packaging to form asset-backed commercial paper (“ABCP”) programmes and collateralized debt obligations (“CDOs”) can serve to spread the risk of low rated debt assets (US sub prime mortgage debt for example) across a wide range of lenders or investors but at the same time this process, results in a reduction in the ability of lenders and investors to readily identify risk concentration and its location. Similarly, while one might have thought that the growth of insurance against credit default should result in the spread, and therefore reduction, of credit risk for market participants this does not inexorably follow. The now infamous LMX reinsurance spiral which virtually brought the Lloyds insurance market to its knees is testimony to the potentially disastrous consequences of slicing and dicing insurance risk through reinsurance programmes among a group of market participants in a manner that the location and concentration of risk ceased to be transparent or capable of proper assessment. There may not be a direct analogy with credit insurance in the form of credit default swaps (“CDSs”) written by a group of the larger international banks but their now widespread use has also resulted in less transparency of the location and concentration of credit market risks and increased the prospect of distorted risk assessments by market participants.

The securitisation process typically involves the sale of debt assets to a bankruptcy remote special purpose vehicle (“SPV”) in return for immediate cash payment and that vehicle raises the immediate cash payment through the issue of debt securities in the form of tradable loan notes or commercial paper. The types of securitisation structured used varies. ABCP programmes are generally established by commercial banks to reduce regulatory capital requirements by funding debt securities portfolios off-balance sheet and typically require committed bank liquidity facilities. Structured investment vehicles (“SIVs”) which are similar to ABCP programmes invest in investment-grade debt securities in accordance with individual asset and portfolio limits agreed with credit rating agencies. A SIV will fund itself by issuing senior debt (commercial paper and medium term loan rates) and capital (subordinate capital notes or funding shares) which may be held by the sponsoring bank and act as a credit enhancement for the senior debt. In general SIVs are more actively managed than the ABCP programmes and CDOs as they target capital returns to investors and investment management fees rather than simply a reduction in the regulatory capital requirements of a bank.

Again in principle, at least at first blush, the conduct of banking activities by banks through separate off balance sheet corporate vehicles to insulate against the risk of credit default should facilitate the availability of finance in the credit markets and reduce credit risks. However the establishment by banks of these SPVs has not had this effect. Risk has not simply been transferred to a diversified investor pool but in many cases flows back to the originating bank(s). The involvement of banks with the SPV varies from one or more of the following activities: management through an affiliate asset manager, provision of finance, acting as guarantor and last resort liquidity provider, entering into CDS transactions, acting as the collateral custodian and/or security trustee through affiliates, acting as lead manager and sponsor for a stock exchange listing or acting as a placement agent for investments in a SIV. The structural separation of an SPV from a bank may insulate a bank to some degree from credit default but it does not facilitate the maintenance of market confidence and integrity overall. First, the creditworthiness of an SPV is not as transparent or clear as that of a bank and does not encourage market confidence when credit defaults occur. SPV investors may have been given only limited access to information about the SPV portfolio of debt assets or other collateral and may have relied solely on credit ratings from a third-party agency. Secondly, a bank may find that its extensive involvement with an SPV will give rise to material liabilities, if not legal, then the liabilities to assuage any loss of reputation if its first tier customers were introduced by the bank to SPV investments (as is frequently the case) which then suffer substantial losses. These characteristics of SPVs which make counterparty credit assessments more difficult (not only of SPVs but of market participants in general) in periods where concerns about credit defaults are rising in fact accelerate losses of market confidence and reductions in credit market liquidity.

## **UK Credit Market Regulation**

### Scope of Regulated Activities

The Financial Services and Markets Act 2000 ("FSMA") governs most investment services in the UK but not all the services which might be regarded as banking activities. For the most part, FSMA regulated investment business does not include the simple provision of finance which is unregulated (except for domestic mortgage lending). Some lending which is in the form of the provision of credit to individual consumers in amounts of £25,000 or less is regulated by the Consumer Credit Act 1974 ("CCA"). While the conduct of the core activity of providing finance in the global credit markets may not be regulated as such in the UK most other activities of a bank are regulated.

FSMA regulated investment business includes the activity of accepting deposits if the money received by way of deposit is lent to others or any other activity of the person accepting the

deposit is financed out of the capital of, or interest on, money received by way of deposit. Money accepted as a deposit is deemed not to be a deposit for the purposes of FSMA if it is received for the consideration for the issue of debentures, loan stock, bonds or other similar instrument creating or acknowledging indebtedness. (This exclusion only applies to the issuance of commercial paper where it has a maturity date of less than one year if it has a minimum redemption value of £100,000 and is issued only to investment professionals for the purposes of their investment business.)

FSMA regulated investment business also includes the activities of dealing in investments as principal or agent, arranging deals in investments, managing investments and advising upon investments. Investments are defined to include debentures, loan stock, bonds, certificates of deposit, other similar instruments creating or acknowledging indebtedness and options, futures and contracts for differences. Accordingly while receipt of money on issuing loan notes will not constitute the regulated activity of deposit taking any activity taking place in the UK constituting dealing or arranging deals in (that is buying, selling, subscribing for or underwriting) loan notes will be FSMA regulated. Similarly while the activity of making a loan may not of itself be regulated entering into corresponding interest rate swaps and credit default swaps will constitute dealing in a contract for differences and will be regulated (subject to certain exceptions concerning dealing as a principal where there is an absence of any holding out to the public as engaging in investment business).

### Unregulated Activities

To the extent an SPVs activities are limited to debt issuance it may not require FSA authorisation if incorporated in the UK but SPVs will usually be incorporated outside the UK. Most if not all SPVs are incorporated in offshore low tax jurisdictions. Accordingly, most SPVs are not FSA regulated or indeed regulated by any financial services regulator. The manager of an SPV will however, usually be regulated by a financial services regulator, typically the FSA in the UK.

The provision of credit rating assessments is not of itself a regulated investment activity and there is no requirement that credit rating agencies be FSA regulated in the UK.

### Prudential Rules

Where a person is conducting FSMA regulated investment businesses, as all banks operating in the UK credit markets inevitably will, that person will be subject to the FSA's prudential, and systems and controls, rules. There are comprehensive and extensive rules relating to dealing

with credit market risks. Banks must maintain adequate financial resources to deal with prudential risks and regularly report to the FSA in this regard. Prudential risks are defined to include liquidity risks, credit risks and market risks. Securitisation risks are also specifically identified and include the risk that capital resources held by a bank in respect of assets it has securitised are inadequate having regard to the economic substance of the transaction including the degree of risk transfer. Banks are required to have effective systems and controls in relation to granting credit, to assess portfolio credit risks, for dealing with problem credits, for adequate diversification of credit portfolios and dealing with the impact of market risks.

The foregoing does not suggest any shortage of regulatory provisions applicable to regulated financial institutions in the UK with respect to their assessment and management of risks when participated in the credit markets.

#### Disclosure Requirements

In addition, where a bank or financial institution (or indeed an SPV) has its securities listed on an EEA stock exchange it is subject to public disclosure requirements. The Transparency Directive (2004/109/EC) concerns the harmonisation of transparency requirements for information about issuers whose securities are admitted on an EEA regulated market. There are requirements for the publication of annual and half yearly financial reports and interim management reports during each six month period of the issuers financial year.

The Market Abuse Directive (2003/6/EC) also provides at Article 6 that Member States shall ensure that issuers of financial instruments inform the public as soon as possible of inside information (information likely to have a significant effect on the price of the financial instruments) which directly concerns the issuer. By way of derogation from this disclosure obligation an issuer may under his own responsibility delay the public disclosure of inside information such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided the issuer is able to ensure the confidentiality of that information. It is further provided as an example of a legitimate interest that public disclosure may be delayed for a limited period in the event that the financial viability of the issuer is in grave and imminent danger, and where such a public disclosure would seriously jeopardise the interest of existing and potential shareholders by undermining the conclusion of specific negotiations designed to ensure the long-term financial recovery of the issuer. The precise scope of this derogation was in issue with respect to the disclosure of Bank of England funding support for Northern Rock but the derogation was clearly intended to provide flexibility where disclosure might be counter productive for investors in the listed entity.

## **Adequacy of Credit Market Regulation**

The call for regulation to require greater disclosure by banks and SPVs of their assets was precipitated by the rapid reduction in available finance through commercial paper issuance by SPVs which generated a loss of confidence in credit ratings and creditworthiness between market participants which in turn significantly tightened credit conditions in the money markets and the interbank market. It may have been considered that if SPVs immediately disclosed any losses they may have incurred then improved counterparty credit assessments could be made, market confidence might be restored and credit conditions might return to normal.

There are, however, some difficulties with this approach. First SPVs in many cases only exist to enable banks to conduct banking activities which their regulatory capital base might not otherwise sustain. The reduction in liquidity can be interpreted as a re-evaluation of the extent to which market participants wish to lend to SPVs in general (even if the ability to make counterparty credit assessments were to improve). Second, and perhaps more importantly, regulations requiring ongoing public financial disclosures could have significant repercussions and costs and such an approach is not consistent with general regulatory models adopted to regulate the solvency of regulated market participants.

The banking regulatory system is premised upon the supervisory authority, the FSA in the UK, monitoring compliance by regulated market participants with their financial resource requirements and financial institutions regularly reporting on their solvency. The financial resource requirements are set to have specific regard to the prudential risks of liquidity risk, credit risk and securitisation risk in particular and it is not believed any criticism is made of the adequacy of these requirements. A system predicated upon market participants maintaining an open book to the public upon the details of their balance sheet and asset holdings is probably not feasible. If losses (including contingent liabilities anticipated with respect to any SPV exposures) suffered by a financial institution were to cause a failure to meet regulatory financial resource requirements then that would be disclosed to the market. Otherwise disclosure of such losses may occur in the case of listed entities either in interim trading statements or the annual or half yearly financial reports. In exceptional cases where the losses are sufficient to be likely to have a significant effect on the issuers share price an immediate public disclosure is required.

The real regulatory issue is not one of disclosure but the absence of regulation of SPVs generally because they are typically located offshore. But this is not a new issue and is very familiar to the funds industry of which a significant part is constituted by offshore unregulated funds. The same issue arose in the context of the split capital trusts affair after which Treasury embarked upon lengthy consultations. To date no extension of regulation has been considered appropriate. In broad terms it is difficult to confer legal regulatory jurisdiction on the FSA to regulate funds or entities which are based in another jurisdiction. The pragmatic approach adopted is that the financial promotion of offshore funds and investments is restricted to professional or sophisticated investors. Professional market participants who are FSA regulated that may invest in or deal with these offshore entities are then subject to extensive rules concerning risk management.

While accounting standards and regulatory capital reporting requirements have come under scrutiny there is nothing to suggest that an inadequacy in this regard has contributed to the credit market problems now in issue. Questions may well be asked, and should be asked, as to whether regulated market participants have applied these requirements properly and no doubt this will be a focus of forthcoming FSA supervisory visits but a case for regulatory change in this respect has not to date been made out.

EU finance ministers are seeking a review of credit rating agency regulation especially in relation to structured finance instruments. There are concerns about conflicts of interest where agencies provide risk consultancy services to banks and act as independent rating agencies, about the transparency of rating agency methods and about time lags in rating reassessments. Whether these concerns warrant the introduction of legislation is doubtful as rating agencies have clear commercial incentives to introduce an industry code of standards to deal with these concerns. Ultimately, as noted above, it is the responsibility of professional lenders and investors to conduct appropriate due diligence and credit assessments of which rating information received from such agencies forms but a part. The assessments made by professional investors with respect to loans and investments to SPVs at the height of the credit cycle may now in some cases look imprudent but perhaps the focus should be on the application of their own internal risk assessment systems and controls rather than the reliability of credit ratings from credit rating agencies the limitations of which are widely known.

## **Conclusion**

In 2005 Alan Greenspan warned on the need for market participants and policy makers to be aware of the risk management challenges associated with the use of credit derivative products to transfer risk both within and outside the banking system: that challenge persists for the credit

markets today but it may be that it is best met by market participants focusing on their risk assessment and management systems and controls and by supervision of the regulators of market participants in that regard. A move towards more regulation in the form of either more onerous public disclosure requirements or regulation of offshore entities or regulation of credit rating agencies may just divert attention from the central risk management issues at the expense of more regulatory bureaucracy which may have far reaching implications unconnected with the immediate credit market liquidity concerns.