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Chief Executive Officer

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Dear Sir or Madam,

### **Operations and risk management in the credit derivatives market**

We are sending this letter to all financial institutions that are active in the credit derivatives market. It will be published on our website on Tuesday 22<sup>nd</sup> February accompanied by a press notice. The objective of this letter is to draw your attention to a specific operational issue about credit derivatives that merits action.

We have recently undertaken a market sounding of the operational activities of a number of firms engaged in the credit derivatives market. This was partly as follow up to international enquiries into credit derivatives, including most recently a wide-ranging investigation by the Joint Forum.<sup>1</sup>

### **Background – FSA rules and guidance on Credit Derivatives Transactions**

Sound risk management is extremely important for all firms. This is expressed in the FSA's Principles for Business: Principle 3 reads "A firm must take reasonable care to organise and control its affairs responsibly and effectively"

We have set out rules and guidance on risk management in the FSA Handbook. You can find guidance on general activities in the over-the-counter (OTC) derivatives market in the Interim Prudential Sourcebook<sup>2</sup>. Our Senior Management Arrangements, Systems and Controls

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<sup>1</sup> A cross-sectoral group combining the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

<sup>2</sup> Interim Prudential Sourcebook (IPRU(Bank)) - Chapter CD and IPRU(Investment business) - Appendix 63 and rules 10-170 to 10-176 for counterparty risk requirements, rules 10-80, 10-100 to 10-111 for position risk requirements, and rules 10-74(2) for illiquid positions .

Sourcebook also contains relevant guidance<sup>3</sup>. Furthermore, we have published a discussion paper on Credit Derivatives<sup>4</sup>, which points to the importance of effective risk management. Looking forward, the new Basel Accord and the EU Capital Requirements Directive will detail minimum capital requirements for credit derivatives.<sup>5</sup>

### **Outstanding Confirmations**

Various studies on credit derivatives have clearly illustrated the benefits of credit derivatives and commented on emerging good practice in individual firms and cross-industry initiatives. However, we believe that more can be done to reduce operational and settlement risks. The difficulties of back-office functions keeping pace with the rapidly developing front office trading activity were highlighted during the Joint Forum's investigation and the FSA's soundings of firms confirmed this.

Specifically we are concerned about the level of unsigned confirmations with some transactions remaining unconfirmed for months. Although we recognise that work undertaken in 2004 is helping reduce the backlog, levels of unsigned confirmations and master agreements remain relatively high and raise serious issues for market efficiency and market confidence.

We ask you to consider your firm's operational processes and risk management frameworks - and the resourcing of these in relation to credit derivatives - to assess their robustness in this rapidly evolving market. Confirmations and other documentation should be issued and affirmed promptly after the transaction has been agreed.

Again, we are pleased that some remedial action has already been taken - by individual firms, market infrastructure providers and through industry bodies. For example, many of you are participating in International Swaps and Derivatives Association's strategic plan to tackle outstanding confirmations in OTC derivatives. We propose monitoring the progress and impact of industry efforts over the short to medium term. The success of industry initiatives would certainly help to allay regulatory concerns.

Firms should expect FSA supervisors of UK authorised firms to be taking an increased interest in credit derivative operational performance and risk management controls. Our supervisors will be giving particular attention to the quality of management information and its use by senior management.

### **Calculation and paying agent communications**

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<sup>3</sup> See Systems and Controls Sourcebook (SYSC) 3.2.11-12G for general guidance; and SYSC 3.2.20-21G for guidance on records of dealings.

<sup>4</sup> DP 11 Published in May 2002.

<sup>5</sup> The detail of minimum capital requirements for credit derivatives in the banking book are given in paragraphs 140 to 142, 189 to 210 (Standardised Approach) and 300 to 307, 332 to 333, 480 to 489 (IRB). The treatment in the trading book falls under paragraphs 684 to 718.

One additional operational issue that is creating market inefficiency is firms' communications to paying agents. We are aware that the communication mechanism for disseminating rate-fixing information used for calculating interest and principal payments is not always effective. This is particularly common in financial institutions originating structured debt with a related derivative which accept the role of calculation agent but not of paying agent. The calculation agent should ensure it has in place an effective system for advising paying agents and issuers on a timely basis of all rate or index determinations. This is so custodians and investors may in turn be notified of impending cash movements. Industry participants may wish to consider opening a dialogue on this issue to work on improving communications.

### **Summary of actions**

I want to finish by stressing that we are aware that the credit derivatives market provides a number of benefits: as a tool for diversifying risk and as a method for bringing increased liquidity to all segments of the credit market. But with these benefits come risks. If simple operational procedures are unable to keep up with the pace of market development, the risk that misunderstandings and uncertainty will negatively impact market confidence increases. To this end, I ask you to satisfy yourself that the necessary operational steps are being taken to ensure compliance with your responsibilities for effective systems and controls. And more specifically the necessary steps are in place to tackle the level of outstanding confirmations in credit derivatives.

Yours sincerely,

A handwritten signature in black ink that reads 'Gay Huey Evans'. The signature is written in a cursive, flowing style.

Gay Huey Evans  
Director, Markets Division  
Capital Markets Sector Leader