# The Archegos saga demonstrates once again that banks' and financial institutions' quest for huge returns trumps prudent risk management

Once again, the following quote attributed to philosopher George Santayana is being invoked: "those who do not learn from history are doomed to repeat it." A variation on this quote is "those who cannot remember the past are condemned to repeat."

Is it a question of shortness of memory on the part of financial institutions, or is it just a matter of the prospect of huge returns making risky investment decisions worthwhile? Whatever the motivation, the Archegos implosion has prompted regulators in the US, UK, Switzerland and Japan to investigate the risk controls of eight major banks including Credit Suisse, Nomura, Morgan Stanley, UBS, MUFG and Mizuho, who collectively suffered losses in excess of US$10 billion.

The New York headquartered Archegos Capital Management is an asset management company that straddles banking and securities financing transactions. In the regulation and supervision of banks, financial soundness of the institution possibly overshadows other considerations. In the regulation and supervision of securities firms, depending on the nature of their activities, governance of business and market conduct considerations dominate, whilst financial soundness remains relevant. Regardless of the differences in the business models of banks and securities firms, there is a significant commonality of issues and concerns, hence the joint letter dated 10 December 2021 from the Bank of England (BOE) and the Financial Conduct Authority (FCA) to firms involved in the equity finance business. The focus was on counterparty risk management. Banks and securities financing firms in the UK are being compelled to review the roles of the front office (first line of defence), also known as operational management, the oversight function of risk management (second line of defence) and senior management.

We have been here before. Gary Gensler, the US Securities and Exchange Commission Chair harked back to the USD 3.6 billion collapse of the hedge fund Long-Term Capital Management, which had used swaps to leverage its position more than two decades ago. We are reminded that in 2008, at the time of the last global financial crisis (GFC), over-the-counter derivatives and their leverage effect through prime brokers, again caused big banks to suffer significant losses.

The financial instrument at the centre of the Archegos failure is the total return swap or contract for difference. These terms tend to be utilised interchangeably depending on the location of the parties involved.

In the securities industry intermediaries include brokers, broker-dealers and prime brokers. The services offered by the prime brokerage businesses to their clients include trading services, processing of trades and the provision of credit. This arrangement, which exposes prime brokerages to significant credit and other risks, enables clients such as hedge funds and family offices to invest multiples of the "margin" they deposit with the bank in everything from equities to complex derivatives. A family office is a one-stop financial shop for the extremely wealthy, providing wealth management and financial advisory services to high net worth or more likely, ultra-high net worth clients.

The principal of the Archegos family office is one Bill Hwang, an individual with a chequered history and relationship with the financial services industry. He was the founder of the New York-based hedge fund Tiger Asia Management which in 2012 pleaded guilty to using inside information to trade Chinese bank stocks. This malfeasance resulted in a large settlement with US regulators.

One would have expected members of the banking and finance and community to invoke a higher standard of due diligence and monitoring with Hwang who has been described as an "aggressive moneymaking genius". However, just 12 months after he was forced to return money to investors, he bounced back. Upon his return he set up Archegos Capital Management, and as the Financial Times reports "…soon many of the world's top investment banks were fiercely competing for its business." Interestingly, of the megabanks, Goldman Sachs appeared to hold out the longest apparently concerned about reputational issues. However, it began working with Archegos and Hwang again in 2020 after its bankers convinced the risk department to allow the business.

The world of investment banking, encompassing prime brokerage, is very competitive with investment banks usually form part of financial conglomerate structures. The prime brokerage business is rewarding, though risky. It seems therefore that concerns about Hwang's reputation and history were offset by the significant opportunities that came from dealing with him. To quote the FT "…fee hungry investment banks were ravenous for Hwang's trading commissions and desperate to lend money so he could magnify his bets."

Investment banks fell over themselves to extend credit to Archegos. A question that has been raised is whether in their eagerness to secure the business of Archegos, the investment banks dispensed with concerns about Hwang's reputation, asked minimal questions about Archegos business and failed, deliberately or otherwise, to consider its overall exposure to the industry.

Archegos, took full advantage of the benevolence extended to it by the industry. As such, it was able to enhance its business significantly by entering into swap transactions with numerous banks. A number of banks were lending to Archegos to such an extent that it was 8 times levered. The suspicion in some instances, was that the leverage may have been as high as 20 times.

The real problem for the banks was that, whilst they knew how much counterparty risk they faced individually with Archegos, they had no idea how much the industry as a whole was exposed to Archegos. In the nature of relationships with prime brokerages, clients such as Archegos face minimal scrutiny, a bit like Bernie Madoff and his investment securities business that resembled a Ponzi scheme. Lenders or investors elect not to press for information lest they lose the business or not be taken on as clients. As the BOE opined: "…it is highly concerning that lessons from the Global Financial Crisis have not been learned sufficiently and that necessary changes to business and risk management practices have not been embedded in firms' operations."

The way in which total return swaps or a contract for difference works, is that at the time that the client enters into the contract, the banks with which it trades buy the underlying shares and agree to swap returns based on how the share prices moves. As long as the share prices continued to rise, the contract benefited Archegos.

Predictably, almost as night follows day, these highly concentrated bets on share price movements on a number of companies including ViacomCBS and Discovery, did the unexpected (from the point of view of those jumping onto the Archegos bandwagon) or the expected (from the point of view of the absent or overridden risk manager). Share prices in the investments moved adversely against Archegos. In other words, instead of the share prices increasing, they decreased and Archegos was obliged to make margin payments to its financiers. The amounts were large, and Archegos defaulted on the margin calls.

When Archegos defaulted on its margin calls, the banks were compelled to attempt to minimise their overall loss. They therefore entered into distressed stock sales of the underlying shares which they had acquired under the total return contracts. Distressed sales of blocks of shares or large shareholdings generally serve to exacerbate the downward pressure on the price of those shares. The loss to the banks was therefore increased. The losses they suffered may have exceeded US$10 billion.

Déjà vu for the financial services industry. Recriminations commenced and heads rolled. Fortunately, this time around the impact on financial stability was minimal. The measures taken by bank regulators after the GFC were tested. These measures required banks to improve their loss absorption capacity through increased capital buffers. As a result, Archegos's lenders may have suffered appreciable losses, but their overall viability remained assured.

Yet again risk management within the financial services sector came under the spotlight. Many financial services regulators around the world pride themselves in having adopted a risk-based approach to the supervision of the entities which they regulate. Risk-based supervision is an evolving practice which requires the supervisor to have a detailed knowledge of the entities that it supervises. The supervisor is required to have a deep understanding of the environment in which the entities operate. This includes knowledge of macroeconomic as well as industry factors. Familiarity with the activities of the entities is also required, as is identification of the attendant inherent risks and measures required to be implemented in order to mitigate those risks. The key risks introduced by Archegos were credit and operational-.

Supervisors have been compelled to re-examine the roles that they played, or did not play, in the events leading up to the Archegos failure. The US Securities Exchange Commission has acknowledged that it does not have access to all the relevant information that would enable it to execute its risk mandate adequately. It has therefore proposed certain measures that would require additional disclosures of holdings of security-based swaps once they exceed US$300 million or account for 5% of a company's stock.

The BOE and the FCA have performed forensic analyses of the circumstances and practices leading up to the implosion of Archegos. Financial services entities have been advised that they are expected to carry out systemic reviews of their equity finance businesses. The reviews are required to cover risk management practices and controls, benchmarked against specific findings which have been communicated to the entities. Reports from entities including their findings and detailed plans for remediation, where relevant, have to be submitted by the end of Q1, 2022.

The forensic investigations and analyses carried out by the BOE and FCA identified significant deficiencies in the interface between the front office (first line of defence), risk management (second line of defence) and senior management. Often there was insufficient clarity with respect to the demarcation of responsibilities amongst the different roles.

The BOE and FCA make pertinent observations mainly around credit and operational risk in the entities which they regulate. They go on to provide guidance on how the risks can be better managed.

The following, are some of the observations and recommendations:

Business strategy and organisation

*Observation*: "Comprehensive ownership of risk both within the first and second lines of defence was often hampered by these fragmented organisational arrangements, with separate resourcing models for similar business activities, inconsistent approaches to risk monitoring and disparate analytical tools and capabilities being observed across a number of firms."

*Recommendation*: "Risk measurement, monitoring, and control frameworks, in both the first and second lines of defence, should be consistent and joined up across such business units, enabling a holistic approach to risk ownership and risk management."

Onboarding and reputational risk

*Observation:* "…variance in decision-making standards and methods across firms…" were noted. "In number of instances, there was no committee or senior management forum designated to consider and sign-off on client accounts where due diligence processes raised matters of reputational concern"

"Onboarding arrangements were narrowly focused on KYC and financial crime objectives."

*Recommendation:* "Firms should embed senior-level decision-making governance fora in their reputational risk and client selection processes, with escalation criteria clearly defined"

"Firms should ensure there is adequate oversight of onboarding and reputational risk processes to ensure that the firm's policies and controls are operating effectively."

Documentation standards and contractual rights

*Observation:* "Many contractual provisions in client agreements are based upon commercial decisions… some firms had adopted sub-optimal protections for the risk management of certain type of client exposure profile."

*Recommendation:* "Firms should have consistent and robust policies and procedures for the negotiation of client agreements and contractual terms"

"Processes should include appropriate escalation and governance procedures for contractual arrangements that are outside of established risk appetite."

Margining

*Observation*: "Some firms had adopted static margining terms for clients' total return swap financing exposures"

*"*…reliance by firms on standard calibration of their dynamic margin terms was misplaced, proving to be insufficiently sensitive to concentration risk"

"Some firms were seen to employ different margining approaches, both static and dynamic, …with no effective standards controlling consistency of use."

*Recommendation:* "There should be clearly defined policies and procedures covering different types of margin methodology adopted by firms for products with a similar risk profile. Firms should establish a formal risk appetite for deviations from their standard margin terms, and put in place arrangements to measure and monitor exposures against this risk appetite. This risk appetite, measurement and monitoring process should be independently owned by the second line of defence."

Ongoing due diligence and disclosures

*Observation:* Firms did not require, through contractual provisions, routine disclosure of the wider financing relationships and investment exposures of their hedge fund and family office clients."

"Net asset value disclosures…failed to consider or determine whether such information was independently prepared or verified."

*Recommendation*: "Risk management practices, including client on boarding decisions, setting of risk limits and margin requirements, should formally take into account the level of disclosures provided by individual accounts. Firms should assess their ongoing account due diligence processes to ensure that adequate proof, supporting assurances and verification is sought with respect to client financial disclosures."

Risk management and governance

*Observation*: "For smaller or less established businesses, there was no specialist in-business risk resource. As a result, dedicated or specialist resources were not available to support risk ownership or to inform risk-taking decisions within the first line of defence."

*"*Independent risk management groups in the second line of defence typically set a formal risk appetite using a limit framework. In a number of cases, this group was seen to lack the stature necessary to control risk effectively. Escalation procedures were ill-defined, management reporting was insufficiently timely and targeted, and growing exposure concerns and risk appetite exceptions were not flagged clearly."

*Recommendation*: "Where no dedicated in-business risk resources are employed, firms should ensure that the scale, nature and complexity of their business activities are appropriately calibrated to the front office's capacity and capabilities."

"Firms should review their escalation policies and procedures within both the first and second lines of defence to ensure that escalation triggers for exceptions to risk appetite are clearly articulated and followed up in a timely manner."

<u>Limit frameworks:</u>

*Observation*: "Firms independent risk functions generally used a Potential Exposure model to set formal counterparty risk limits and to monitor exposures."

"Limit breaches were in some cases ignored. Potential Exposure measurements did not, by definition, capture extreme tail events relevant to highly concentrated portfolio compositions such as in the case of Archegos."

"Furthermore, in some cases, independent risk management functions only carried out ad hoc monitoring of outputs from stress loss models that were managed and controlled by the first line of defence, without clearly articulated links to the firms' risk appetite framework."

*Recommendation*: "Firms should ensure that their independent counterparty risk limit and systematic exposure monitoring frameworks are sufficiently comprehensive to adequately represent their risk appetite for all types of client portfolio exposure, including highly concentrated positions under stress."

Often it takes the implosion of a company such as Archegos to get supervisors and the industry to introspect, consider what they have been doing or not doing, and formulate remedial action.

The issues surfaced by the failure of Archegos are not new, having been encountered to an extent, in the case of the Long-Term Capital Management failure and more recently the GFC.

This case illustrates the importance of an understanding of the key inherent risks faced by entities offering equity financing transactions, and also the supervisor’s expectation for the mitigation of these risks. Risk mitigation can be enhanced by a clear demarcation and understanding of the roles of the first line of defence, second line of defence and senior management.

To assess whether or not their expectations have been met, supervisors can adopt a company specific approach or an industry approach where suspected poor practices are widespread.

In closing, “those who do not learn from history are doomed to repeat it.”

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