Controlling legal risks in financial asset management

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Legal risks are prevalent in financial asset management but seldom feature in overall risk calculations, where the emphasis is rather on financial risk. One reason for this is probably that legal risks seldom materialise, besides being difficult to measure and evaluate. But if they do materialise, the damage can be considerable because these risks reside in the legal conditions for limiting credit risk. There is therefore every reason to take legal risk seriously. This is done by creating the best possible conditions for controlling risk. Just as in the case of other types of risk, controlling it aims to provide predictability and thereby a possibility of taking calculated risks.

Besides being common in an activity that manages financial assets,[1] seldom materialising and thereby difficult to measure and evaluate, legal risk is a concept that is difficult to define. Still, this article will first try to construct a picture of the legal risks that can occur in financial asset management. In the light of that picture, the aim is to describe some basic conditions for achieving sound control of the legal risk. Control in this context stands for the identification, analysis and limitation of the legal risks.

A discussion of the concept of legal risk is followed an account of the principal conditions for controlling the legal risks in asset management and, finally, of the practical conditions for such control.

Legal risk in financial asset management

Legal risk in financial asset management occurs primarily in the legal conditions for limiting credit risk.

In the management of financial assets, legal risk occurs primarily in the legal conditions for limiting credit risk. Some examples of arrangements for limiting credit risk that have a particularly clear foundation in important legal conditions are asset protection through right of reclamation and

[1] In the following, the phrase *activity that manages financial assets* is abbreviated in most cases to various forms of the word *activity*.

transfer of title, netting of outstanding transactions (i.e. settlement), and guarantees.

The terms may require some clarification. Right of reclamation means that instead of being included in the insolvent estate, the assets are held separately from the counterparty's own assets in favour of the owners. Netting, or settlement, is similar to but not the same as offsetting. The main rule for offsetting is that payment shall be due for an offsettable claim, whereas settlement concerns claims that are not due for payment and is usually arranged by agreement. A case in point is standard agreements for derivative transactions, e.g. ISDA.[2] Simplifying somewhat, in settlement under ISDA, the transactions of a defaulting party cease to exist and the market values of outstanding transactions are netted out. Thus, the residual claim on or liability to the counterparty consists in the net value of all outstanding transactions. Given that this can be presumed to function, the day-to-day calculation of credit risk can use the same settlement arrangement – as if a counterparty has defaulted – and result in a lower exposure to that counterparty.[3] With an arrangement for transfer of title, credit risk can be further reduced by, in principle, transferring securities to match the net value of those with a positive value. Guarantees are used, for example, when a counterparty or instrument (strictly speaking, the issuer) does not meet the solvency standard that the activity has set, often by specifying the level of a counterparty's external credit rating. This can be resolved by requiring a guarantee from a more solvent associate – usually the parent company – or a sovereign.

A feature that arrangements for limiting credit risk have in common is that they will not function as intended if the legal conditions are not in place. In other words, they involve a large element of potential legal risk: perhaps a country's insolvency rules do not support the expected asset protection, for instance right of reclamation, or the agreed form of netting of outstanding transactions and perhaps the guarantee is either ruled out by the guarantor's statutes or national law or has other deficiencies that prevent it from working as intended.

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Another approach to controlling legal risk involves reviewing the division of responsibility between the parties and ensuring that it is sufficiently clear to as far as possible avoid unnecessary and costly legal disputes and that it represents what the activity allows for and can accept responsibility for in reality.

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2 International Swaps and Derivatives Association, Inc.

3 In corresponding repo agreements published by ICMA (International Capital Market Association), netting is closer to offsetting in that the buy-back is accelerated, i.e. the transaction still exists but is concluded – allowed to mature, as it were – in advance, whereupon the market values of the transactions are calculated and netted out. All these arrangements for securing credit involve a large element of potential legal risk because they do not work as intended if the legal conditions are lacking.

Then there is, of course, an operational risk in the actual execution of the control of legal risks. There is an operational legal risk if, for example, documents are faulty due to ignorance, carelessness or omission, or if the conditions have not been examined carefully enough.

In the light of these examples, the following definition or summary and subsequent description can help to indicate where legal risks are to be found in financial asset management:

Legal risk is a risk of loss being occasioned primarily by assets being unprotected due to uncertainty about or shortcomings in the legal conditions for protecting these assets, and to inadequate control of these legal conditions.

THE CRITERION OF LOSS

The first part of the definition can be called "the criterion of loss". It stipulates that a risk of loss exists because assets are unprotected. Some ways in which loss can arise are as follows:

Assets can be lost because registration, reclamation, etc. lack support in an agreement or in current legal rules or because the assets are not otherwise properly protected.

Assets in the form of claims that are secured by agreement may be lost if the agreement is not enforceable or invalid (e.g. the counterparty's guaranteed commitments).

Agreed settlement, offsetting, etc. do not function either due to an imperfect agreement or because the relevant jurisdiction does not support bilaterally agreed settlement or offsetting.

The division of responsibility between the contracting parties is either not commensurate with the responsibility the activity has deemed acceptable or is unclear, with an increased risk of costly and time-consuming legal disputes.

THE CRITERION OF CAUSE

The other part of the definition can be called "the criterion of cause" because it specifies the causes of loss which make the risk of loss one that is deemed to have a legal origin. This is made up of three partial definitions:

Uncertainty about the conditions

The first of these partial definitions – uncertainty about the legal conditions – implies that control has been exercised as well as possible, or at least in keeping with the activity's objective, but that legal risk of an unknown or uncertain nature still exists. Such risk naturally tends to be difficult to calculate but, provided the activity has opted for the appropriate level of control, in many cases the risk should be something the activity is prepared to take or at least consider. If the activity has no idea about the risk and this turns out to be substantial, either the level of control is at fault or it is a matter of legal risk that overlaps some other category of risk (see below).

Shortcomings of conditions

The second partial definition concerns cases where the level of control is adequate (as in the previous partial definition) but where the risk is recognised and the probability of loss can be calculated and included in the overall estimation of risks and earnings.

Inadequate control of conditions

The third partial definition states that control is inadequate due e.g. to ignorance, carelessness or performance errors, i.e. an operational legal risk.

Briefly, then, there are risks that are either accepted or not, depending on the activity's aversion to risk; in such cases, control has been exercised, at least up to the level set by the activity, and under these conditions there is nothing more to do. Then there are risks inside the bounds of control, i.e. operational risks in the control function as such. The latter originate inside the activity and are easier to limit – at least in theory – with internal measures. The following can serve as an illustrative example of the former risks, those that can be either accepted or not:

First, there are risks that remain after control has been exercised and that are either accepted or not, then there are operational risks in the exercise of control.

It is not unusual to require a counterparty to present documentary evidence of internal authority to be a party to a particular agreement and type of transaction. However hard one tries, the point may be reached where such documentation is simply not procurable. Perhaps the counterparty's structure or the national rules under which it operates does not require such documentation. There is then no operational risk as defined in this article – control has been exercised to the full. But there is still a legal risk to consider.

Another example of doing everything possible or complying with control requirements and still being left with legal uncertainty is when an external legal opinion has been obtained and turns out to be incomplete or too vague.

As regards the first – and perhaps to some extent the second – partial definition, there is a notion that any matters beyond the influence of individual market participants, e.g. unexpected changes in the law or legal decisions, do not constitute legal risks. It can no doubt be argued that it is possible to avoid countries with a reputation for uncertainty in these respects. That ought to reduce the risk of being caught by such surprises. Moreover, as the risk has a legal origin, it ought to be included in the concept whether it is a question of legal uncertainty or a perceived legal risk. But it can also be argued that as the risk lies in the unpredictability of the legislative power of a foreign state, it borders on *political risk*. Another borderline case – verging on operational risk – can be said to lie in a counterparty's operational risk, i.e. handling errors on the part of a counterparty's personnel, etc. In most cases, however, such risks no doubt belong to counterparty risk, which in turn can be seen as subordinate to credit risk. In the absence of a legal origin, it can be argued that such risk does not belong, any more than ordinary own operational risk, to legal risk. At the same time, the effect of a counterparty's operational risk can be limited by a judicious division of responsibility in the agreement.

The above attempt at a definition is intended to be a guide or test matrix for obtaining a clearer picture of the legal risks in the activity. Once again, however, the dividing lines from other risk categories are diffuse and in striving for a definition it is all too easy to get lost in a line of reasoning that is rather academic and thereby equally difficult to turn to practical account.

Even so, this picture of risk can serve a purpose in the work of providing the activity with good conditions for controlling legal risk. This issue will be considered in principle and then more practically in the following sections. But first some words about the difficulties in measuring and evaluating legal risk.

MEASURING AND EVALUATING LEGAL RISK

Legal risk is difficult to measure separately from other risk categories.

As indicated, legal risk is difficult to measure separately from other risk categories. Methods are often available for calculating credit risk, for example, in addition to the credit ratings from competent institutions. Such methods are seldom directly applicable to legal risk, with the possible exception of assessments of judicial systems.[4] Moreover, legal risk is characterised, as mentioned, by low probability but a high degree of damage if the risk were to materialise. Furthermore, the probability of a legal risk materialising is often dependent on the probability of other risks, primarily credit risk. If a counterparty does become insolvent, the proba-

[4] For an attempt by Carolyn Jackson at a regression model with 14 critical variables, see Risk.net, September 2002/Vol. 15/No. 9.

bility of a legal risk coming to light and materialising grows with the risk that the arrangement for limiting credit risk (e.g. a guarantee) will be utilised. The result of the work on limiting legal risk will then show up. But not until then. The effect or some confirmation of the quality of the control of legal risk is often not evident until it is too late. All one can try to obtain in advance is a measure of the loss to the activity if a guarantee, agreement, right of reclamation, offsetting, settlement, etc. were not to function. It is not hard to understand that such a loss could be substantial.

Control conditions in principle

PRINCIPLES FOR CONTROL

Legal risks were described above as belonging to one of two categories: (*i*) risks that, after control (identification, analysis and limitation), remain as an element in a decision to either take or refrain from a business opportunity, for instance, and (*ii*) risks in the performance of control that have to do with ignorance, carelessness or omission, i.e. legal operational risks. The level of adequate control should be set for each activity so that when control has been carried out, only risks in category (*i*) above remain (or, to be realistic, these risks plus some degree of operational risk – as defined in this article – that can be expected to remain despite good intentions). The management of risks in this category then depends on the activity's level of risk aversion. I shall enlarge on this in the following and then devote the rest of the article to how an activity can achieve adequate control of the legal risks.

Identification

The control of legal risks starts from an understanding of the legal structures (the national legal system as well as foreign legal systems and agreements) that affect the activity's assets, claims and obligations. When this has been achieved, it is possible to obtain a good picture of the implications of acting or of refraining from action in accordance with these legal structures. That picture is then assessed in relation to the activity's administrative conditions, level of risk and other requirements. Legal risks in the activity have then been *identified.*

Analysis and limitation

When these legal risks have been *analysed*, a decision can be made on the extent to which limiting them is justifiable in terms of strategic and business considerations. The third step is to *limit* risks in so far as this is required by the activity, is commercially justifiable or actually feasible. The remaining legal risks (category *i* above) are either those the activity has decided to take or, if limitation is judged to be too costly or unfeasible, those that contribute to decisions to refrain from business opportunities, etc.

The purpose of control

A proper understanding of what control of legal risk is intended to achieve can start from the activity's objective: to manage financial assets with a view to maintaining and if possible increasing their value. Seen from this angle, legal risk is on a par with other risks in asset management. Control, moreover, serves the same purpose, namely to ensure that the basic premises for a decision on, for example, a business transaction hold and that each transaction proceeds and is concluded in accordance with the initial assumptions.

If it materialises, a legal risk can lead to costs, missed profits and loss of assets that were not allowed for and which can make the transaction, for example, unprofitable. This is precisely what control of legal risk – as of most other risks – is about: creating predictability and possibilities of taking calculated risks with a limited amount of uncertainty.

The ambition need not be to render the activity completely free from legal risk.

As indicated, the ambition need not be to render the activity completely free from legal risk (apart from operational risk). The effort to minimise risk is not meant to go so far that the activity misses business opportunities unnecessarily or incurs unnecessary costs. Obtaining the agreement that is most risk-free can take time and meanwhile business may be lost. It is a matter of achieving an expedite negotiation without this entailing a division of risk that is unacceptable for the activity. Risks are a normal feature of most activities and in certain cases the probability of a feared outcome actually happening is so small that, provided the activity's risk profile is met, the risk is worth taking, assuming that this is calculated to improve earnings. In other words, the level of protection should be weighed against the probability of loss and potential profit (see the example below). This task is usually beyond the legal function on its own and therefore calls for close cooperation with other functions in asset management. This brings us to the division of the performance of and responsibility for control of legal risk, which is considered in the next section.

THE LEGAL FUNCTION AND RESPONSIBILITY FOR LEGAL RISK

The activity's legal support is central to the task of controlling legal risk. The value of legal support in financial asset management lies in the scrutiny of legal conditions for the activity. This work should therefore be done by a legal function together with other parts of the activity but the legal function should direct it. Given a sufficiently competent and properly dimensioned legal function (see below), the most suitable summary description of a legal function's task concerning legal risk therefore seems to be the following: legal risks are *those risks that a legal function is most suited to help to control*.[5] Here there is a natural limitation both in the levels of training and experience normally to be found in a legal function and in the expression "*help to*" – the legal function is not ultimately accountable for the legal risk as such. Product responsibility naturally rests with the producer but the formal responsibility is often located outside the legal function. In most cases this is also the most appropriate arrangement: the legal risks have to be considered together with other risks in relation to expected costs and earnings.

Directing and, together with the rest of the activity, performing control of legal risk is the task of the legal function.

Consider the following example:

A new counterparty is to be used for a particular type of transaction in which the credit risk is customarily limited by means of the combination of a netting agreement, let us say an ISDA agreement, and title transfers equivalent to the exposure after all outstanding transactions have been netted out. The legal function points out that it is uncertain whether or not the counterparty's national legal system supports the intended transfer of title. In the light of that information, the risk control function can adjust its calculations of risk exposure and the limits on the counterparty in question. The new picture of risk results in an increased risk exposure to just this counterparty, so that a larger part of the limit is utilised. The business function then has to calculate the benefit of carrying out the planned transactions even so. Perhaps the decision is to go through with the transactions but with maturities that are shorter than planned initially in order to reduce risk exposure over time.

A legal function can certainly be of assistance by making its contribution to this estimate of a business opportunity but is not best suited to make the overall assessment. That task and the attendant responsibility should lie with the part of the activity that undertakes the object of legal risk control, for example a transaction, the procurement of a depositary, etc.[6] At the same time, cases may arise where the legal risk applies to the activity as a whole, not just to an estimated profit. The legal risk can be so large that doing anything along the planned lines is perceived as haz-

A legal function can assist in the calculation of a business opportunity but is not best suited to make the overall assessment.

5 See Whittaker, A. M., (2003), Lawyers as risk managers, *Journal of International Banking and Financial Law*, Vol. 18, No. 1, January.

6 At the Riksbank, the Market Operations Department is accountable for investment, while responsibility for the procurement of depositaries and other intermediaries is shared with the Administration Department, which includes the Financial Administration Division (the Riksbank's back office).

ardous, for example because that would considerably damage the activity's reputation. In such cases it is important that the general counsel has a right of escalation, that is, a possibility of referring matters directly to the executive management.

Practical conditions for control

FUNCTION OF THE ACTIVITY

We turn now to the control of legal risk in the activity as a whole and the role of the lawyers in this respect. To make control of legal risk as effective as possible, all relevant branches of the activity should participate in the entire process. It is also important that everything is properly documented for the collective memory and that procurers have – and take – the overriding responsibility throughout the process. This applies not least to the negotiation of agreements and other "project-like" items of control. Likening the negotiation of a agreement to the construction of a vehicle, for example, it is more suitable for the parts to be assembled into a finished product by a single team than to have an assembly line. The team typically consists of the procurer (usually the dealer or front office function when a transaction agreement is being negotiated, or the administrative or back office function if the agreement has more to do with administrative matters),[7] the back office function, the risk-control support function[8] and the legal function. The optimal situation is for all functions to have a proper picture of each other's fields of responsibility and a clear understanding of the purpose of the agreement. It is likewise important that, instead of being confined to the legal function, knowledge of the agreement's content is acquired to a relevant extent by every function. That also serves to limit the operational risks when the agreement is used (see below).

An example of how administrative routines can facilitate such an approach is the formalisation of cooperation, both to assemble the basis for a business decision to ensure that every aspect has been considered and to preserve the basis as an aid for the collective memory. The Riksbank, for example, applies a standard model for cooperation – an "application procedure" – with respect to a counterparty, a market or an instrument that is new to the activity. The competent department distributes an application to use the counterparty, market or instrument and this is annotated by each department and signed by the department head (the

[7] For example, agreements on depositories, correspondent banks and clearing.

[8] The risk control function is sometimes referred to as *middle office*; strictly speaking, however, a middle office monitors results, while the risk control function focuses on levels of risk.

departments note the conditions the object of the application should fulfil, seen from their perspectives, the risks involved, the measures and steps they recommend, etc.). The information in the application then serves as a basis for the applicant department head's decision as to whether or not the counterparty, for example, is to be accepted and under what conditions. Once a counterparty, instrument or market has been "approved", a new – perhaps less exhaustive – application has to be made as soon as a change of some weight occurs, for instance a new agreement or type of transaction with an approved counterparty, additional activity in an approved market, etc.

The Riksbank applies a standardised model for cooperation with respect to a new counterparty, a new market or a new instrument.

AWARENESS OF LEGAL RISKS

It may happen that other functions in an activity see an agreement as an out-and-out legal product which therefore does not concern them. Such an attitude is deleterious not only for a proper negotiation of the agreement but also for its future use. For the lawyers, control of the legal risks presupposes sound knowledge of the activity in general and in particular, of course, of what the agreement is about. It is equally important that those who are to act under or administer a completed agreement really understand how the agreement works. In the final analysis, an agreement documents what has been agreed with a counterparty, that is, what one wants from the counterparty, what one has promised to do for the counterparty and, not least, how the risks are to be shared. For the day-to-day business activity it is therefore highly important that each function in an activity is continuously clear about relevant aspects of the content. This is necessary, for instance, in order to evaluate information from the market in the light of what the agreement has to say about the rights and possibilities of limiting risks (insolvency rules, etc.). The legal function seldom follows the daily management of financial assets and seldom has the market contacts that are needed for a reaction to improprieties and disturbances. Moreover, transactions and confirmation of them need to be carried out in accordance with the agreement in order to be covered by this. To promote uniformity, another good idea is to use standard agreements as far as possible and to try to limit the number of standards as well as the number of judicial systems involved. Such an attitude facilitates the

Those who act under or administer a completed agreement must understand how the agreement works.

organisation's understanding of and ability to react to counterparty failure (see below), besides contributing to the aim of restraining costs and the possibilities of limiting risks.[9]

Awareness of the agreement and the division of risks between the parties also means that credit exposure can be adjusted accordingly.

If the activity is aware of the agreement and thereby of the division of risks between the parties, credit exposure can be adjusted accordingly. Given a sound comparison of costs and receipts, in which the former include legal risks (i.e. calculated risks) and the collective is continuously aware of the risks that have been taken, there is as mentioned nothing wrong about taking a risk, even of a legal nature. But continuous awareness of these risks is a precondition for a calculation that holds.

READINESS

As legal risks seldom materialise, a readiness exercise is liable to have less priority relative to day-to-day activities.

It is not sufficient, however, for the activity's entire organisation to be aware of agreed relationships, divisions of risk and rules for responsibility, though this is indeed a precondition for the organisation's readiness to cope with crises, e.g. counterparty failure. The activity should also perform exercises, as in all other crisis readiness, be prepared to trigger the available protective mechanisms, for instance in agreements, rearrange transactions, cancel payments, notify counterparties and so on. Here, too, the nature of legal risk can be an obstacle: as legal risks seldom materialise, a readiness exercise concerning counterparty failure, for example, is liable to have less priority relative to day-to-day activities. Such an attitude is about as logical as refraining from fire-drill because fires are so infrequent. Much of the work on limiting legal risk is about providing the activity with a tool-kit to use in the event of a crisis. Once a crisis, e.g. a counterparty failure, is at hand, there is often no time to spare. If, for example, the front office has to get hold of a lawyer who in turn has to peruse the agreement before informing the back office that it must notify the counterparty that a time limit is being set and the formulation of such a notification then has to be worked out, time will be lost unnecessarily and this may well lead to losses. In this respect, too, it can be advanta-

[9] It is better to build up internal competence in English law, for example, and strive to write agreements on this basis than to give counterparties a free choice. The activity is then in a better position to cope internally because it is easier to focus on acquiring internal experience of and competence in one judicial system. If it then proves impossible to gain acceptance for the chosen judicial system in a particular case, greater use can be made of external specialist competence but there is no reason why this should be a common occurrence. Most international banks can consider using English as well as New York law because they are often represented in both London and New York, with the possible exception of parent company guarantees, which are preferably drawn up for the judicial system in which the parent company is domiciled. For matters to do with insolvency, on the other hand, the judicial system is dependent on the choice of counterparty. In the case, for example, of netting claims under a standardised transaction agreement, e.g. ISDA or ICMA, the organisation in question publishes legal opinions for particular judicial systems. In other cases it is advisable to request such an opinion.

geous for the legal function to initiate training, organisational structures for crisis management and exercises.

LEGAL SUPPORT

The dimension and competence of legal support for an organisation depend on the nature of the latter's activities and conditions. Bearing that in mind, one can still point to some issues to consider when an activity reviews its legal support with a view to providing optimal conditions for good control of the legal risks.

The lawyers should work closely with other support functions as well as with procurement functions. That does not mean that the lawyers should belong to the same department as the procurers. On the contrary, it is important that lawyers can express an opinion without being influenced by the procurer (the person responsible for the business or process) also being their superior. Another important reason is that a separate assembly of lawyers facilitates advice and discussion between them, which in turn enhances the reliability and quality of their opinions.[10]

The internal legal support needs to be dimensioned so that it has procurement competence for every occasion and can handle internal coordination.

It need hardly be said that legal consultants should be used as cost-effectively as possible. Financial asset management frequently involves foreign judicial systems and the questions that arise tend to require such a variety of specialist knowledge that it is not sufficiently cost-effective to dimension internal legal support so that it could cope with every imaginable issue. Expert specialist assistance is almost invariably needed. Regardless of the extent to which external consultants are used, it is important that the internal legal support is at least dimensioned so that it has procurement competence for every occasion and can handle the internal coordination of different parts of the activity for the control of legal risks. But such a dimension is to be seen as a minimum requirement because the more one out-sources to consultants, the more difficult it becomes to maintain the collective memory of different agreements when it comes to the future use of agreements and future negotiations on agreements. For each activity there is no doubt an optimal balance between internal and external inputs that it is advisable to identify and uphold. A solution in the normal case would be to restrict the use of consultants to ensuring quality, providing a dialogue and meeting the need of specialist competence in foreign law, with the proviso that the internal

[10] In a sizeable organisation, a legal function can, of course, be created where a number of lawyers are responsible for financial asset management only, while the more general legal function is as a rule a function at a central administrative level. The more specialised function for financial asset management can then be headed by a general counsel equal in rank to the head of the business side, which upholds the integrity of the legal function. The right to refer matters to the executive management is, of course, no less important with such a division of the legal resources.

legal support directs the work and undertakes the main contacts and negotiations with the counterparty. Such a solution helps to maintain the collective awareness in a long-term supportive way at the same time as the activity itself receives further training, which contributes to cost-effectiveness in the longer run.