



## 2007 LEGAL AND REPUTATIONAL RISK PRIORITIES

**EXECUTIVE SUMMARY:** The banking regulators and SEC have formalized guidelines addressing legal and reputational risk, exposing banks, broker-dealers and investment advisers to heightened penalties if laws, rules, regulatory expectations and current views on “appropriate” or “moral” conduct are breached or perceive to have been breached. Below, we detail the changes that heighten legal/reputational risk in structured finance and briefly describe top areas of concern.

On January 5, the federal banking agencies and the Securities and Exchange Commission issued long-awaited guidance on the degree to which firms may engage in complex structured finance transactions (CSFTs). “Elevated-risk” CSFTs – that is, those subject to potential regulatory sanction – are defined by legal and reputational risk, not the more traditional credit, market, and operational ones.

Unfortunately, the guidance does not indicate how institutions are to identify legal and reputational risk. Companies historically have had the most trouble with these risks because:

- they can’t be measured, priced or anticipated in a quantitative fashion;
- legal and government-relations officers are often in different reporting lines and have no formal responsibility for risk management; and
- senior management and boards of directors lack a routine process for anticipating legal and reputational risk. Instead, firms all too often are forced to respond to these risks only after they become unfortunate, costly realities.

Although legal/reputational risk is not subject to quantitative analysis, disciplined, forward-looking assessments can guide strategic planning and risk management. Based on current factors, Federal Financial Analytics has identified the following priority legal and reputational risk factors:

- Questionable Assets: With a new Democratic Congress, unflattering attention is turning to subprime mortgages and credit-card practices. CDOs and other tranching asset-backed securities have enabled underwriters and investors to target credit risk to desired levels. However, this still means that positions are being structured and/or held in assets subject to growing criticism about underlying origination practices. Legislation requiring securitizers to monitor

origination practices and extending assignee liability to investors is anticipated. Regulations and/or litigation requiring forbearance or reversing mortgage foreclosures will affect both reputational and credit risk in MBS and home-equity/HELOC ABS. Universal-default provisions may be reversed.

- Compensation: Overall executive compensation is about to get a very hard going-over from the new Congress. As a result, the SEC and bank regulators will seek high-profile enforcement cases to show that current rules are, in fact, tough enough. A lightning-rod is compensation in complex structures hidden to investors or set in a way that regulators believe undermines safety and soundness.
- Inside Information: Diversified financial institutions are of course on various sides of complex transactions, for example often finding themselves both lenders and debt/equity underwriters and on two sides of a credit derivative. Growing financial institution involvement in private-equity funds also poses potential conflicts of interest about to get a hard look from Congress. Legal and reputational risks related to insider knowledge have largely been addressed between individual institutions and aggrieved customers, with regulators so far willing to permit industry voluntary standards and self-regulation. However, pressure from Congress is growing for more specific and binding standards, leading to potential harsh enforcement actions to avert criticism of the regulatory agencies.
- Suitability: As more complex transactions are brought to retail investors, accusations will increase that products are sold without due regard to suitability. Asset managers outside brokers are not held to an express suitability standard. However, they, along with brokers, will be subject to harsh regulatory action and subsequent reputational risk unless sales practices are documented and long-term suitability clearly considered.
- Customers: Any transactions in which either counterparties or customers are questionable from a national-origin or corruption-risk perspective have heightened legal and reputational risk in 2007. U.S. branches of foreign commercial and investment banks will be subject to harsh supervisory action and even termination of a U.S. license if sanctioned transactions are in any way facilitated in the U.S. Reputational risk pertains not only to currently-sanctioned nations and entities (e.g., North Korea, Iran), but also to problematic countries (e.g., Venezuela, Nigeria). As always, doing any sort of business subject to accusations related to money laundering poses significant legal and reputational risk.