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**DEALS & DEAL MAKERS**

# Critics Fear Bank 'Firewalls' Also May Have Some Cracks

## Big Insurers, Fund Managers Say Barriers Between Lending, Trading Were Breached

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The so-called firewalls between different departments of Wall Street firms, constructed to prevent conflicts, are triggering a firestorm of criticism.

Last week, regulators alleged that the "walls" separating securities firms' investment-banking and stock-research departments were breached, triggering a regulatory settlement under which top financial firms paid a total of \$1.4 billion for misleading small investors through overly optimistic research on companies that also were investment-banking clients.

Now, critics contend that the walls between banks' lending operations and their trading desks may have broken down as well.

At issue are complaints by some of the nation's biggest insurance and fund-management companies that the lending departments of some banks are telling traders at their firms of pending problems at corporate clients, allowing the traders to act before the information is made public. Specifically, they contend that the bankers are sharing confidential information about credit woes of clients, prompting the traders to place bets in the unregulated derivatives market that allow them to get the better end of positions.

"You can't help but suspect the trading side and the lending side

**COMPANIES**Dow Jones, [Reuters](#)[J.P. Morgan Chase & Co. \(JPM\)](#)

PRICE	24.20
CHANGE	<b>-0.51</b>
U.S. dollars	12/24

[Mitsubishi Tokyo Financial Group Inc. AD \(MTF\)](#)

PRICE	5.32
CHANGE	0.00
U.S. dollars	12/24

[Deutsche Bank AG ADS \(DB\)](#)

PRICE	46.81
CHANGE	<b>0.06</b>
U.S. dollars	12/24

[ABN Amro Holding N.V. ADS \(ABN\)](#)

PRICE	15.71
CHANGE	<b>-0.09</b>
U.S. dollars	12/24

[Bank of America Corp. \(BAC\)](#)

PRICE	69.75
CHANGE	<b>-0.36</b>
U.S. dollars	12/24

[Citigroup Inc. \(C\)](#)

PRICE	36.50
CHANGE	<b>-1.18</b>
U.S. dollars	12/24

\* At Market Close

are communicating," says Zhengyuan Lu, a director of the CIFG subsidiary of Paris-based CDS IXIS Financial Guaranty NA Inc., a relatively new entrant in the business of providing insurance on financings.

The center of the storm: an arena known as the "credit-default swaps" market. This is where banks, hedge funds and other market participants buy protection against corporate defaults from sellers, mainly insurers and fund-management companies.

The sellers -- many of whom have lost money in the market over the past year -- are suspicious because the credit-default swap market frequently has moved in advance of the disclosure of sensitive data about companies. That information could involve anything from whether the company is obtaining a big line of credit to whether it is violating the terms of its loans to whether it is the subject of a regulatory probe.

Consider the trading activity in the weeks leading up to the Feb. 8 extension of two \$2 billion revolving credit facilities to **Weyerhaeuser** Co. by a bank group led by **J.P. Morgan Chase & Co.** and units of **Bank of Tokyo-Mitsubishi** and **Deutsche Bank** AG. In mid-January, credit-default swap deals were being struck at \$90,000 for \$10 million of protection against a Weyerhaeuser default. In early February, days before the deal was announced, prices surged to as high as \$155,000, with no negative news in the market to explain the move. (In recent days, Weyerhaeuser has seen a drop in the price of protection to \$115,000 for \$10 million of protection after trading as high as \$160,000 in October, when the market was particularly nervous about all corporate credits.)

"Whether it is Weyerhaeuser or any other loan, our credit-derivatives desk does not have access to the loan pipeline," says John Coffey, a managing director with J.P. Morgan Chase. "That is standard procedure." Spokesmen for Bank of Tokyo-Mitsubishi and Deutsche Bank declined to comment.

Other banks also strongly deny any wrongdoing in this market, as do the dealers who make markets, buying and selling protection for customers on both sides of any transaction. "Because the credit-default swap market is a platform where it is easy to express negative sentiments, this market often leads on the way down," says Jared Epstein, chief credit-derivatives trader for Morgan Stanley. "And that can be misconstrued as front running."

Bank regulators also suggest that nothing is amiss. "We spend a lot of time on the issue of potential conflicts of interest," says Kathryn Dick, deputy comptroller for risk evaluation at the Office of the Comptroller of the Currency in Washington D.C. "Banks clearly have an obligation to make sure that they are not trading on insider information. They can't afford to sacrifice their reputation for a quick killing" on a trade.

There hasn't yet been any litigation involving the assertions, according to Kimberley Summe, general counsel of the International Swap Dealers Association. "There is no case law and there is no legislation," she says. Moreover, there is no consensus on whether the protection bought in the credit-default swap market qualifies as securities and therefore would be subject to Securities and Exchange Commission rules on the matter.

Nevertheless, the swap-dealers group, along with the Bond Market Association and the Loan Syndication and Trading Association jointly are looking into such allegations, considering what constitutes inappropriate use of information and establishing standards of behavior, officials at these groups say.

Complicating the situation is the fact that it isn't clear who is on the other side of the transactions with the insurers and fund managers. For example, the cost of protection on **AOL Time Warner Inc.** surged from \$350,000 for \$10 million of protection to \$585,000 between July 1 and July 2 of this year. A week later, on July 8, the media conglomerate announced agreement on credit lines totaling \$10 billion through a syndicate of 27 banks. The five agent banks included units of **ABN Amro Holding NV**, **Bank of America Corp.**, **BNP Paribas SA**, **Citigroup Inc.** and J.P. Morgan Chase. The first three banks couldn't immediately be reached for comment. A spokesman for Citigroup declined to comment. The Chase spokesman says the bank's position on AOL is consistent with its remarks on Weyerhaeuser.

Even many dealers weren't certain whether the buyers were banks hedging their lending exposure or other market participants betting -- mistakenly, as it turned out -- that the media conglomerate wouldn't be able to get the line. The deal was struck when the market was particularly nervous about the viability of all media and telecom companies, in the weeks following WorldCom Inc.'s filing for protection under Chapter 11 of the Bankruptcy Code. At the time the financing was arranged, AOL's chief financial officer, Wayne Pace, referred to the "confidence in the company's financial stability that the banks and investment banks are showing."

"Virtually every time you'd see a huge premium [increase], a week or two later, something would happen," asserts Chris Dialynas, a managing director at giant bond-specialty firm Pacific Investment Management Co., or Pimco. "Somebody knows, and that is why they are willing to pay so much compared to the bond market."

The dispute about whether there is improper trading took on added intensity following the June restructuring of a \$7 billion credit line to **Xerox Corp.** In that instance, a different sort of conflict is alleged: that the banks control talks with borrowers such as Xerox and can force them to agree to changes in loan terms in such a way that they trigger payments under their credit-default insurance policies -- even as they still anticipate being paid back in full on their loans.

Seven of the biggest providers of protection wrote to the International Swap Dealers Association in protest following a banking group's decision to extend the term of Xerox's loan 30 months beyond the original due date of October 2001. While the extension is expected to give Xerox the breathing room it needs to repay the banks, it still qualified as a "restructuring" under terms of the insurance policies. The banks didn't even have to surrender their loans to collect under the policies. They simply delivered Xerox securities selling at less than face value to the counterparties who had sold them the protection against default. They conceivably could have bought up bonds trading at 70 cents on the dollar and received 100 cents -- all the while expecting repayment from Xerox in 2005. The value of the claims isn't known, but analysts estimate it could amount to hundreds of millions of dollars.

"The definition has proved to be unworkable," the letter writers note. "The definitions should be revised to leave no doubt that a restructuring does not include ordinary loan refinancings." Insurers who signed the letter included Ambac Credit Products LLC, Financial Security Assurance Inc. and MBIA Insurance Corp.

In response to sellers' concerns, market leader J.P. Morgan Chase has announced that it is willing to sacrifice restructuring as a trigger for payouts.

"There is a perception of a conflict of interest on the part of banks operating simultaneously in the lending and derivatives market, and that is hurting liquidity," says Blythe Masters, head of risk management at the bank. "Restructuring has become the greatest source of uncertainty and potential for dispute in what is a crucially important risk-distribution channel for banks."

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