

# FINANCIAL risks today

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May-June 2012

## Fixed income

With the eurocrisis continuing, how much of a safe house is fixed income?

## SGX interview

Muthukrishnan Ramaswami talks about the risks and issues surrounding SGX

## Credit risk

Four years into the downturn, how are the credit markets faring?



## Doing it the Latin way

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How are the Latin American exchanges continuing their growth story?

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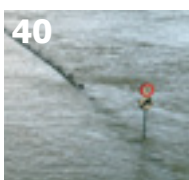
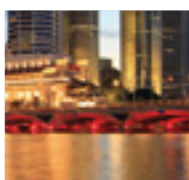
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## Editor's comment

In this issue we welcome the first in what we hope are many risk manager profiles. If your company, or yourself would like to be profiled, drop me a line at the address below.

As always we are keen to hear from you, the reader, and you can contact us through the links below or through twitter: @FinancialRisks

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### COVER STORY LatAm

How do Latin American exchanges continue their growth story?

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## editor's letter



**A**s I write this editorial, the eurozone is in another spasm as money supply goes down, Greece faces its 'Grexit' and Ireland votes on the fiscal pact. The problem with the eurozone is that all attempts to offset the crisis have resulted in temporary lulls followed by runs on various embattled southern European countries' debt. There is a reason for this - the fundamental issues with the eurozone have not been addressed. Yes, there is a need to get excessive spending under control but without control over its own money, Greece, for example, finds itself without any sugar to swallow the bitter pill. The whole area is in a paralysis over addressing the issue that the system is at fault.

In true fiscal unions, such as the United States and the United Kingdom, money is taken from the richer areas to fund the poorer areas - a true debt transfer. Without full debt transfer, the eurozone is going to continue its way spending vast monies on expensive sticking plasters over the wound that will eventually fester. For the eurozone, the question has to be asked: what do you want from the single currency? If you think that you can continue your way without discipline, you are mistaken. On the other hand, if, like Germany, you think that you can impose austerity without the back-ups to support the embattled countries then you too are wrong. The only answer to the eurozone problem is, ironically, the one that euro-sceptics warned about all those years ago - a currency can only work with full fiscal and political union.

### Taxing the City

Sticking with Europe for a minute, one idea that is gaining strength is the financial transaction tax (FTT) that has been voted for by the European Parliament. Surely, creating conditions that would drive finance companies away is not the most intelligent option in these difficult times? Whether you agree with an FTT or not — and fundamentally I do not — driving finance houses away from Europe and adding costs to pensions and investment funds is not the way to solve the crisis. And that is before we get onto the subject of who will actually pay the bill - London. Not only do the EC's own figures point to a 90 per cent drop in derivative trading but also, with 80 per cent of derivative trades in London, how can European parliamentarians honestly believe that this is not a tax fundamentally targeted at the UK in the same way that a luxury car tax would disproportionately hit Germany?

### Ringing in the summer

Finally, this Summer will bring its own risks to the citizens of London when the Olympics come to town. For those of us that are not going on holiday, this will mean overcrowding and late running of trains, people piling into the capital and restaurants and bars overflowing as visitors sample the City. In fact much like a normal day really. I hope that the Games will show London is its best light and that the appetite the UK has for sport is demonstrated during the Olympics. Whichever country you support, hope you enjoy the games. ●

# Move towards active management of counterparty credit risk with CVA



# news

## Yen/Yuan currency trade

Japan and China have started trading their currencies directly in Tokyo and Shanghai from 1 June.

The move follows an agreement by the two countries in December last year which also sees Japan buying Chinese government debt.

By trading directly, it eliminates the use of the dollar to set the exchange rate and is part of Chinese strategy to reduce dependence on the US currency. The China Foreign Exchange Trade System said it will provide the market-making system.

## RBS: no return for shareholders

RBS shareholders who owned RBS shares before its £45.5bn bailout, are likely to die before getting their money back.

At the bank's AGM, chairman Sir Philip Hampton commented: "I don't think shareholders wealth is likely to be restored any time in my lifetime or some lifetimes beyond. Many thousands of shareholders lost an awful lot of money. We've still got a lot of baggage to clear up."

## Rothschild/Rockefeller

Two of the worlds oldest financial dynasties have teamed up in a strategic partnership.

Lord Rothchild's RIT Capital Partners will acquire a 37% stake in Rockefeller Financial Services, previously held by Société Générale Private Banking and will become a significant minority investor in Rockefeller Financial Services.

The firms intend to collaborate on investment solutions and other areas of shared expertise to further serve the needs of their clients and investors.

## Eurozone money supply

The eurozone's monetary supply contracted again in April according to the latest figures from the European Central Bank.

Battered by the ongoing crisis in the region and the threatened withdrawal by Greece, the M3 money rose at annualised rate of 2.5% in April, below expectations for a gain of 3.4%. M3 money supply in the eurozone rose 3.1% in the preceding month, revised down from 3.2%.

## EC: banking union needed

The European Commission has recommended that the eurozone should move to a banking union and consider directly recapitalising banks from its permanent bailout fund.

In its report into the economic state of EU countries, it said the vicious circle of weak banks and indebted sovereigns lending to each other needs to be broken.

"A closer integration among the euro area countries in supervisory structures and practices, in cross-border crisis management and burden sharing, towards a 'banking union', would be an important complement to the current structure" of Europe's economic and monetary union, the Commission said.

It added: "In the same vein, to sever the link between banks and the sovereigns, direct recapitalisation by the ESM might be envisaged."

The report is seen as an attempt to find a solution to Spain's banking crisis.



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Active management of counterparty credit risk requires that your trading desks have an accurate real-time measure of the Credit Value Adjustment (CVA), so they can choose the best counterparty to deal with, and set the right price on the risk.

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# news

## FSA publishes fees

The Financial Services Authority (FSA) has published a policy statement confirming its regulatory fees and levies for 2012/13.

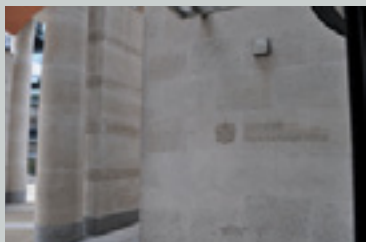
On 2 February 2012 the FSA launched a consultation on its proposed fees, which cover its Annual Funding Requirement (AFR). Following that process and finalisation of its annual accounts, the FSA has reduced the amount firms will be required to pay.

The overall AFR has been reduced by £18.6m (3.2%) from the proposed figure of £578.4m to £559.8m. This compares to £500.5m for the 2011/12 year, which now represents an increase in annual funding of 11.9%, compared to the 15.6% increase proposed in the original consultation.

## FSA sets record fine

The UK's Financial Services Authority has handed down its largest ever fine to an individual in a non-market abuse case. The fine of £3m and banning from regulated financial services was handed down to Dynamic Decisions Capital Management CEO and director Alberto Micalizzi. Jonathon Crook, partner in the Financial Services Dispute Resolution group at international law firm Eversheds, commented: "The FSA seems to have reached the view that Micalizzi orchestrated a fraud in order to conceal from his investors the massive losses that were being incurred by his hedge fund."

**£3m**  
The largest ever UK fine for non-market abuse



## Canaccord to list on LSE

Canaccord Financial has announced its intention to list on the main London Stock Exchange market.

In May, the company announced its intentions to cancel the admission of Canaccord shares onto AIM.

It said that the move would benefit the expanded company following the purchase of Stewart Hawkpoint.

It is expected that admission will take place on or shortly after June 29.

## Yes we do need education

The UK's education system is one of the biggest threats to the economy according to a European Union report.

European Centre for the Development of Vocational Training warned: "The UK continues to have too many people with low skills, resulting in inequality and skills mismatches. The economic costs of this problem are likely to increase over time if it is not effectively addressed." It added that Britain had "higher levels of early school leavers than the EU average for all subgroups except for migrants", with the proportion increasing by 3.3 percentage points since 2005 to 14.9%.

## Government damage Barclays

The government damaged Barclays over a tax disclosure, its CEO Bob Diamond told MPS in May.

In a letter to the head of the Treasury Select Committee Andrew Tyrie, Diamond accused the Treasury of breaking taxpayer confidentiality with officials identifying the bank as being at the centre of a £500m tax avoidance row.

He wrote: "The way this situation was handled seems to us completely unwarranted."

"Unnecessary damage was placed on Barclays' reputation just at a time when the focus should be rebuilding confidence and accelerating growth, not undermining it."

The letter has been passed onto the Treasury by Tyrie and he has requested comment from the Chancellor of the Exchequer George Osborne which could lead to a committee appearance.

**£500m**  
Amount involved in Barclays' UK tax row





## Spanish banks to merge after housing crash

Three Spanish banks are to merge as a result of funding pressures following the property crash in the country and the ongoing eurozone crisis.

Ibercaja, Liberbank and Caja 3 will merge after they struggled with around €11.8bn (£9.6bn) in toxic real estate including loans to property developers.

The merger is the result of government pressure to consolidate and develop capital positions to protect themselves from the fallout, not only from their debt, but also the wider European crisis. Spanish banks were hit by the country's property crash and have already written off €84bn in losses against property portfolios this year. Banks have until 11 June to demonstrate that they will meet the new capital demands and 30 June to put forward any merger plans. The government has appointed consultants Oliver Wyman and Roland Berger to carry out an audit of Spanish banks, which may result in further mergers and consolidation.

The deal would create the country's seventh-biggest entity with more than €115bn in assets and the merger will see Ibercaja holding a 46.5% stake in the company while Liberbank would have 45.5% with Caja 3 holding the remaining 8%. In addition, a merger will give them a two-year margin to meet capital requirements rather than one.

## HKEx to offer renminbi

Hong Kong Exchanges and Clearing Limited (HKEx) has received approval from the Securities and Futures Commission to offer renminbi (RMB) currency futures and plans to introduce them in the third quarter of this year, subject to market readiness. They will be the first exchange-traded currency futures settled in RMB.

HKEx's RMB currency futures will require delivery of US dollars (USD) by the seller and payment of the Final Settlement Value in RMB by the buyer at maturity. Contracts will be quoted in RMB per USD (for example, RMB 6.2500 per USD) and margined in RMB, with the trading and settlement fees charged in RMB. The final settlement price of the contracts will be based on the spot USD/CNY(HK) fixing published by the Treasury Market Association at 11:15 am on the Last Trading Day.

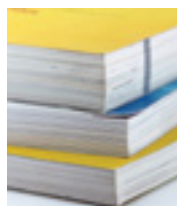
The launch date of RMB currency futures will be announced in due course.

## ASX launches Equity OTC Clear

The Australian Stock Exchange (ASX) has launched Equity OTC Clear, which allows ASX participants to anonymously report transactions in over-the-counter equity options. The ASX's service does not require participants to lodge an International Swaps and Derivatives Association contract.

"The transactions are registered anonymously with our clearing house and the contract is cleared in a similar way as a regular listed equity option," said David Stocken, ASX senior manager, institutional sales. "The OTC contract will portfolio-margin against listed equity option positions and investors can also lodge stock as acceptable collateral against their OTC position."

## IOSCO checks credit agencies



The International Organisation of Securities Commissions (IOSCO) has published a consultation report, *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*. The report describes certain internal controls and procedures that credit rating agencies (CRAs) use to promote the integrity of the credit rating process and address conflicts of interest, with a view

to promoting a better understanding of these practices. The views of stakeholders and CRAs on these questions will assist the IOSCO with further analysis of the internal controls and procedures used by CRAs.

The report is based on an IOSCO review of CRAs that focused on the internal controls established by CRAs to enhance the integrity of the credit rating process and on the procedures to manage conflicts of interest. The review was motivated by the role of CRAs in the 2008 financial crisis, which raised concerns about the quality of credit ratings and credit rating methodologies, the timeliness of adjustments to credit ratings, and, more generally, the integrity of the credit rating process.



## RBC gets interest income

Royal Bank of Canada (RBC) has announced that it has resolved several tax matters and will release approximately C\$130m (£87.8m) of tax uncertainty provisions previously recorded against businesses which were discontinued in previous years.



In addition, RBC will earn interest income of C\$70m (C\$50m after-tax) related to a refund of taxes paid in previous years. The financial impact of this settlement will be reflected in RBC's third quarter results.

The Toronto-based bank has total assets of about C\$800bn, and earned C\$1.6bn in the second quarter 2012.



## China to launch crude oil futures

China aims to launch crude oil futures within the year, allowing trading by foreign investors as the country speeds the opening of its commodities futures market to overseas players, the chairman of the Shanghai Futures Exchange (SHFE) said on Monday.

Once the crude oil contract is launched, the SHFE will gradually allow foreign investors to trade on other contracts, with non-ferrous metals products next in line followed by precious metals.

"The launch of crude oil futures is not merely about the Shanghai Futures Exchange having a new contract, but it symbolises the gradual opening up of China's commodities futures to foreign investors," Chairman Wang Lihua said at the Shanghai Derivatives Market Forum.

## CBOE claims legal victory

The Illinois Appellate Court has ruled in favor of the Chicago Board Options Exchange (CBOE) and The McGraw-Hill Companies and CME Group Index Services, regarding the index options litigation brought against the International Securities Exchange, (ISE)

The ruling affirms an injunction that prohibits ISE from listing or offering a market for trading in options on either the S&P 500® Index (S&P 500) or the Dow Jones Industrial Average<sup>SM</sup> (DJIA), as to which CBOE holds exclusive licenses. The injunction also forbids The



Options Clearing Corporation (OCC), which clears trading for all US options exchanges, from clearing options on these indexes

unless they are traded pursuant to CBOE's exclusive licenses.

## Equity managers stuck



Equity fund managers are stuck with no place left to go as equity markets across Europe fall and redemptions rise to their highest levels since 2008, according to S&P Capital IQ.

Many fund managers agree that the short-term outlook for European equities is extremely uncertain. In the absence of any confident debate, let alone governmental consensus throughout Europe, portfolio construction has become highly stock-specific.

"A key finding from our annual review of the Europe sector is that portfolio concentrations are tighter than we have seen for several years as managers focus on their highest-conviction ideas," commented Peter

Fuller, fund analyst and sector head at S&P Capital IQ Fund research.

"Typically, these are companies with the balance-sheet strength to finance growth internally in the absence of bank lending. However, whereas in 2011 it was widely recognised that good companies would overcome poor political governance, managers are now acknowledging that even good companies could be in danger."

A look at S&P Capital IQ graded portfolios over 10 days shows that managers are caught between a rock and a hard place. With European equities tumbling, returns for sterling-based investors are being further slashed by sterling's rapid strengthening against the euro. Most managers have raised cash from operating levels to between 5% and 10% of total portfolio assets; and even higher where permissible.



**I picked up my old 1972 Bristol car from the garage the other day having had it nursed through its annual MoT. As I drove away I had**

to adjust the rear view mirror and glanced through it now and again, but still most of my focus was looking forward at the road ahead. This made me wonder why many businesses do not run themselves in this way.

Many businesses focus their management and risk efforts on information that is readily available: sales for the past week, monthly management accounts for the past month, utilisation of some kind or other and so on. This information tends to be black and white, easy to verify, straightforward to access and historic. In itself this gives some potentially misleading and false comfort to people who like deep analysis of facts. While this might be fine for managing day-to-day resources and checking what has happened, is it good enough for today's business environment?

At the time my Bristol was built, when Edward Heath was prime minister, the qualities for management were loyalty to a rigid hierarchy, dammed hard work and being pretty clever. This was in a world when life and business were relatively predictable. Annual accounts were produced many months after the year end, and that worked well. The Cold War prevented true globalisation so competition and supply chain risk was limited. Computers were in university labs and emails and 24/7 connectivity were a dream. Regulations

were less rigid. Some might say they were the good old days.

In today's world, these management qualities are no longer adequate. The speed of change in capital markets, geo-politics, technology, competition from multiple channels and changing business models mean that businesses must pay more attention to the road ahead than ever before. Who would have thought that fax machines, video recorders and car maker British Leyland would have come and gone?

It is the synthesis of information that is now less readily available that can give a better sense of the current and future health of an organisation. What your customers and key staff feel, the quality and reliability of the order book, the future volatility of raw material prices, over reliance on key customers, upcoming regulations and disruptive innovation from new competitors. All of this information is not black and white, it is often impossible to verify and often, it isn't easy to get hold of.

In today's world, which features the Toyota Prius, the incredible speed of the growth of businesses such as Pinterest and the continuing Euro crisis, it's clear that different skills are required. Today, there has to be an acceptance that the world will continue to change at a faster and faster rate and that your business will have to adapt accordingly. Secondly, that the people who are managing and assessing the risk need to be adaptable, creative and comfortable with different shades of ambiguity – as I said, things are no longer black and white. While assessing the health of an organisation today

may not be easy, it won't be any easier a year ahead. But unless you do, the speed of change may well kill any business that performed well last month.

In addition, completely new skills are required, as the ability to collect massive amounts of raw data from many sources, build models to identify trends and patterns to enable decisions to be made, should be critical to all businesses. The ability to review the sector in which you operate and develop scenarios of possible outcomes is, in my view, a necessity.

Having the ability to face the need to radically change your business to meet new competitive models while letting go of all the emotional baggage and history is becoming essential. Dealing with any complacency that might continue to exist in the boardroom, will also be pertinent.

Most organisations do plan ahead, but all too often this is an annual strategy session or budgeting process which is then immediately shelved. In my view, not enough effort is focused on continuous and rigorous scanning of the road ahead. My question to you is: do you know the percentage of your efforts which are focused on the past and the percentage which will be focused on the future?

The question for me is how long will my Bristol car last? Some might say that concerns over emissions will eventually send it to the scrap heap or recycling site. But as Nevada became the first US state to legalise robotic cars earlier this year, my gut instinct tells me that driverless cars are more likely to replace it. ●

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**“While assessing the health of an organisation today may not be easy, it won’t be any easier a year ahead”**



# Technology

Send your technology or electronic trading releases:  
simon.miller@financialriskstoday.com

## Chi-X Japan introduces hosted risk controls

Chi-X Japan has introduced Hosted Risk Controls (HRC), becoming the first market centre in Japan to offer this service.

Chi-X Japan HRC offers Chi-X Japan trading participants a customisable set of pre-trade risk controls — including notional limit, lot size, tradeable stock lists and max shares — for their clients.

The launch comes after the closure of the Chi-X Singapore/SGX dark pool. Credit Suisse is an early adopter of the new service. “As risk controls remain a critical component to their work flow, we are pleased that early adopters like Credit Suisse will be able to offer this service to their clients,” said Yasuo Hamakake, CEO, Chi-X Japan.

## S&P Capital IQ upgrades CreditModel

In response to heightened market volatility and uncertainty, S&P Capital IQ has significantly upgraded CreditModel.

CreditModel is a widely used risk-evaluation tool that provides an easy, efficient and cost-effective method to help users evaluate an organisation’s credit quality by generating credit scores in lowercase letter grades for both public and private firms globally.

CreditModel 2.5 can quickly screen rated and unrated borrowers, counter-parties, customers and suppliers in 227 countries to determine the credit strength of a single company or portfolio of companies.

## FlexTrade Systems becomes an approved ISV with SIX Swiss

FlexTrade Systems has become an approved Independent Software Vendor (ISV) with SIX Swiss Exchange.

FlexTrade will provide direct access to SIX Swiss Exchange via its execution management system, FlexTRADER.

FlexTRADER is a multi-asset trading solution with pre-defined strategies and tactics for both portfolio and single stock trading. The platform provides organically developed real-time and post-trade analytics (FlexTQM), predictive analytics (FlexEdge) as well as risk and cost optimised portfolio trade scheduling (FlexPTS); advanced integrations with major OMSs; integrated real-time allocations and cash management; and smart order routing.

## RTS Realtime ready to manage clients’ Eurex switch

RTS Realtime Systems Group (RTS) has announced that it is preparing for full support of Eurex’s new trading system. RTS aims to help clients to achieve an easy transition to the new system which is due to be introduced in December, pending approvals.

RTS will run both the old and new systems in parallel so that its clients will be ready for the transition to the new architecture from day one, and able to take advantage of the full functionality offered as each phase launches.

Christian Zahm, RTS sales director for Europe, said: “We are ideally suited to help clients through this transition because we will support all facets of the new architecture.”

## Iberclear signs tri-party management service in Spain

Iberclear, the Spanish central securities depository and subsidiary of BME, and the international central securities depository Clearstream have signed an agreement to develop a new tri-party collateral management service for the Spanish market. The service will target the collateralisation of exposures in the Spanish market of Iberclear clients. In the first phase, it will cover the exposures resulting from domestic repo transactions, including the possibility of pledging received assets from a repo transaction with the Spanish central bank in order to get access to central bank money. The service will be launched ahead of regulatory changes to liquidity and collateral management.

## NYSE Euronext introduces its cloud-based platform in Europe

NYSE Technologies, the commercial technology division of NYSE Euronext, has announced the global expansion of its successful Capital Markets Community Platform into Europe and based at NYSE Euronext’s European Liquidity Centre in Basildon, UK.

NYSE Technologies’ Capital Markets Community Platform was designed to increase business agility, simplify market access and reduce trading friction by utilising rapid on-demand computing resources. Originally launched on 1 July 2011 from NYSE Euronext’s US Liquidity Centre in Mahwah, New Jersey, the company claims it is the first cloud based capital markets community platform developed exclusively for the financial services industry.



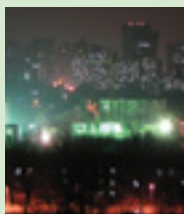


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## Kono takes chair at IOSCO board



The International Organisation of Securities Commissions (IOSCO) has appointed Masamichi Kono as chairman of the new IOSCO board. Kono was appointed during the board's inaugural meeting at its annual conference in Beijing.

At the meeting, Kono gave notice that he would step down from the position in March 2013. The

board elected Greg Medcraft, the chairman of the Australian Securities & Investment Commission to take over as board chairman after Kono stepped down. It was agreed that this transition would take place at the board meeting in Sydney in March 2013, so that Medcraft would assume the position of chair from the end of that meeting until the IOSCO Annual Conference in September.

### Three join Clark on IOR Council

Peter McCormack, John Thirlwell and Dominic Wu have been elected to the Institute of Operational Risk (IOR) joining David Clark, who was re-elected.

The new Council was announced at its annual general meeting and made history by electing Hong Kong-based Wu who became the first director from outside the British Isles. Wu is the head of Chapter in the Far East. Clark is the chairman of the Wholesale Market Brokers Association while McCormack was a former policy advisor on operational risk during the implementation of the Basel Accord.

Thirlwell has lobbied regulators on operational risk in respect of Basel II.

### Cook and Lloyd join Thesis

Thesis Asset Management has hired Lawrence Cook and Neil Lloyd as business development & marketing director and risk & compliance manager respectively as part of its expansion plans. Working with Standard Life for over 25 years, Cook has extensive experience in business development, primarily with professional intermediaries. Most recently he managed the Bristol operation of Towry Wealth Management where he specialised in advice propositions for private clients.

Lloyd has 14 years compliance advisory and oversight experience. Prior to joining Thesis, Neil spent four years at Skandia Group and seven years at Rensburg Investment Management.

### BATS Chi-X get Simpkin

BATS Chi-X Europe has appointed Guy Simpkin as head of business development.

Simpkin, who will initially focus on opportunities in European indexes and derivatives, joins the BATS Chi-X Europe executive committee and reports to Mark Hemsley, chief executive officer of BATS Chi-X Europe.

Hemsley commented: "Guy was deeply involved in all areas of business development for Chi-X Europe and it is a natural progression for him to lead our efforts in this area."

Simpkin is a 27-year industry veteran who has held roles at LIFFE (now NYSE Liffe) and in equity and equity derivatives clearing at LCH.Clearnet.

### ING appoints Den Hollander as chief risk officer

Mark den Hollander, head of ICS Investment Solutions, has been promoted to chief risk officer (CRO) of ING Investment Management (ING IM) effective of 1 June 2012. Den Hollander has close to 20 years of experience in the investment management industry and joined ING IM in 2009 as managing

director, head of Investment Solutions. The appointment, which is subject to regulatory approval, sees Den Hollander take over CRO responsibilities from Satish Bapat, chief financial officer, ING IM, who had been carrying out CRO responsibilities on an interim basis next to his CFO role. Satish will remain CFO of ING IM. Prior to

ING IM, Den Hollander was the chief investment Officer Structured Solutions at Fortis Investments, while before that he held several senior roles with ABN AMRO Asset Management. Den Hollander received his doctorate degree in Econometrics in 1993 at the Erasmus University.



# In hindsight? Perhaps not

**Caspar Berry** looks forwards to see how we shouldn't punish ourselves through hindsight

**B**y the time you read this article, it could likely be out of date. As I write these words, the world is bracing itself for a Greek euro exit – according to *The Independent*. They may well have left. They may not. The simple fact is that — right now — no one actually knows. We're looking at events without the benefit of hindsight which you, the reader, looking back, obviously enjoy.

Hindsight is a wonderful thing. That's been said before. But interestingly, no matter how much one values hindsight consciously, it's so easy to undervalue its effect on us at a subconscious level and assume that the way that something

turned out was the way it was always destined so to do.

Imagine a magician shuffles a deck of cards, places all 52 of them onto a pool table and asks you to bounce the white ball around the cushions until it comes to rest near one. You have a free choice as to which you think is nearest. The magician thinks for a moment and announces that it is the nine of hearts. Absolutely incredible. How on earth does he do it? He turns them all over to reveal 52 nines of hearts. Of course. Easy. That is the only way such a remarkable trick could be performed. And so obvious looking back because — you remember now — that he omitted to show them to you before

performing the illusion.

You project yourself into the body of the person you were ten minutes ago with the knowledge you have now and cannot believe that you didn't guess something so self-evident. But the fact is that before you found out the secret you were oblivious to the crucial information, it was anything but obvious.

According to the Rogers Commission, before the launch of the space shuttle Challenger NASA were aware of the design flaws of Morton Thiokol's O-Ring but failed to address it properly. Remiss of them, of course. But obviously they didn't know that it would lead to an explosion. It was imperfect — as probably was everything else involved with the extraordinary endeavour of propelling man into space. The commission looked back at events as we look back on the magic trick and cannot understand how someone could have made such a mistake because they cannot imagine what it must have been like to have operated without the information that they subconsciously simply take for granted.

As regular readers of this column will know, I make a living talking to companies about all aspects of risk and decision making using poker as my metaphor. At the end of a lot of such sessions, I'll often host a poker game for participants and usually deal a table myself. I work with some of the UK's best managers. They make demanding decisions every day, with limited information and uncertain futures. But



everyone reacts the same when, after having folded a ten and a three in the first two cards, the next three cards are ten, ten, three, thus potentially throwing away a full house. "Why are you bothered?" I say as they berate their bad luck. "Because I would have won the hand," they cry. "But you did the right thing with the information you had available to you," I protest.

Again, consciously they understand the facts but subconsciously they chastise themselves for doing something so apparently stupid! It's bizarre when you stop and think about it. It seems to be the most natural thing in the world to judge a decision not by its intrinsic quality but by the outcome – known only after the event.

Of course the opposite of this is something very challenging to our twenty first century sensibilities: that, away from

the hypothetical baize of the poker table, there is such a thing as an intrinsically good decision irrespective of the outcome. That seems so counterintuitive as almost to make no sense. How can the right decision be one which in actuality ends in failure? Is it possible to judge people independently of short term, noisy and irrelevant results? I would say that it is but that it is so difficult and demanding as to be way beyond the desire – or ken – of most people in management today.

About six weeks ago, the sports section of a UK newspaper debated the suitability of Kenny Dalglish to continue to manage Liverpool in light of their appalling run of results around that time. It was generally agreed by all contributors that Kenny was in trouble but that Liverpool's place in the FA cup final is protecting him: victory in that would probably save him, defeat would

likely consign him to history. But win or lose that 90 minute game he was still the same man with the same essential talents. The question fundamentally is whether, for all his skills and shortcomings, he should continue in the post? Not what result he gets on that particular day – surely?

The journalists concerned apparently believed that that result – above all others – would reveal to us how good a manager Kenny really is. As though the result of a few balls bouncing one way or the other give us greater insight than, for example, going to the training ground to see Dalglish talking to his players or (hypothetically) questioning him for a morning on his tactical responses to opposition formations.

This is tantamount to judging the playability of ten-three in poker by the result of that particular hand. It is openly allowing short term results to decide the answers to much deeper, more challenging concerns and exposing us to the biases of hindsight when judging events and the quality of our decisions given what we knew without its benefits.

It's a utopian cry to get away from being a results-based world, I know. But in a world which moves as fast as this one does; where in a couple of days literally everything can change, it is essential. By the time you read this you will know the outcome of the decisions you're making as I write it. But a long time before that, you should be able to say how intrinsically good they actually are. Can you? ●

CASPAR BERRY, [www.risksanddecisions.com](http://www.risksanddecisions.com)



“It seems to be the most natural thing in the world to judge a decision not by its intrinsic quality but by the outcome”



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# Doing it the Latin way

Although the big exchanges dominate the financial press, Latin America is quietly growing in its own way says **Simon Miller**

**W**hen you think of markets, you generally think of those traditional power-houses of New York, Tokyo and London.

But the global appetite for exchange traded derivatives (ETDs) has seen contracts grow from around nine billion in 2004 to 25 billion contracts according to the latest figures from the World Federation of Exchanges (WFE).

With ETDs heavily weighted in the Americas and Asia Pacific – 40 per cent and 39 per cent of volumes respectively – the global impact of exchange actions can be felt. For example, the 34 per cent decrease in commodity derivative trading volumes in China caused a global decrease of six per cent. To put it another way, if you took out the Chinese figures, commodity derivatives actually grew to 24 per cent.

The growing derivative and clearing markets in Asia are well-known with Singapore [see p30], Hong Kong and Malaysia making a splash in the finance pages. But what about another growth area, that of Latin America (LatAm)?

Emerging after years of financial and political turmoil, its derivative markets are growing benefitting from either scale – as is the case with Brazil – or, as with Mexico, a combination of geography and low-regulatory outlook.

It is easy to see the attractions to foreign investors. LatAm has large natural resources and benefit from increasing

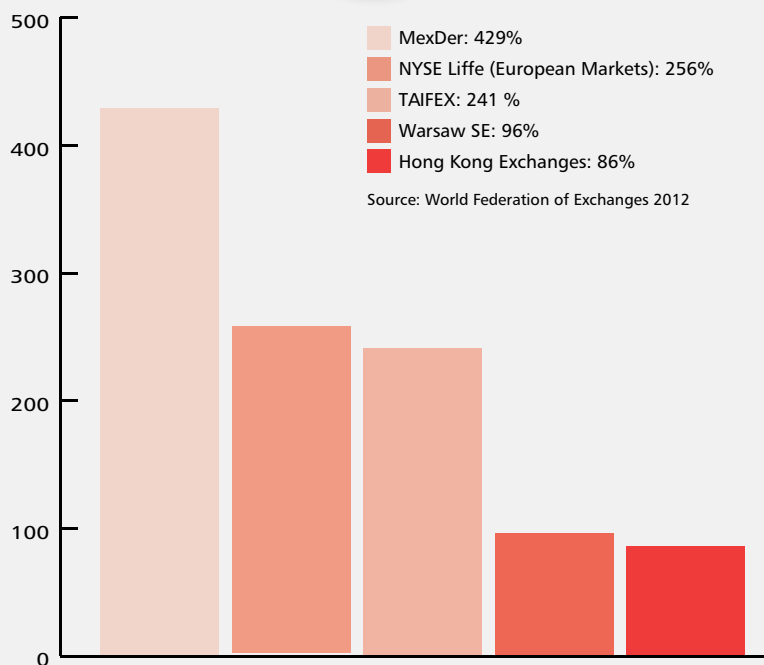
demand for oil from the US and China's appetite for copper and iron ore through the area's role as major commodity producers and exporters.

Brazil is the powerhouse of the region; with stock exchange activity double that of other LatAm countries. The stock market became the third largest exchange in the world in 2008 following the merger of the Sao Paul Stock Exchange

and the Brazilian Mercantile and Futures Exchange and, as of 31 December 2011, it had a market capitalisation of \$1.22trn (£0.78trn). BM&FBPVESAP (Bovespa) remains the biggest single stock option exchange in the world with 838 million of contracts traded with a notional value of \$1.651 trillion.

Alice Botis, head of LatAm business at Fidessa commented: "Brazil is in a really good position because its market has developed

**25** bn  
ETD contracts traded  
in 2011



Source: World Federation of Exchanges 2012

Top five growing single stock futures markets 2011

**“Brazil is in a really good position because its market has developed a lot over the past few years”**

a lot over the past few years, doing a lot to upgrade their technology and they've had the luxury of being able to take a look at much more advanced markets."

However, it is not just Brazil's exchanges that are growing. Both Chile and Mexico are increasing their offerings to the market. Indeed the Mexican derivatives exchange — MexDer — was the fastest growing exchange for the number of single stock futures traded in 2011, with a growth of 429 per cent according to figures from the WFE.

"The foreign players are key growth drivers and we are trying to leverage a very favourable legal and tax framework here in Mexico. So foreign players can play equities and fixed income, foreign exchange without any kind of restriction or holding tax or limitations on foreigners in terms of the need to register themselves separately," says MexDer director general Jorge Alegría.

The one thing that links LatAm is the benefit of coming after the 'western' exchanges, tailoring their regulations and practices in the light of what has happened before such as the flash crash.

"The one thing that they benefit from is that they have been able to put in place the practices they want instead of tripping over the things we have had such as the flash crash. So, the Brazilian exchange, for example, has had a number of these risk checks in place for quite some time," says Botis.

However, it is not simply learning from the western exchanges, it is also about learning from their own mistakes which, in itself brings its own challenges.

As Alegría explains, as regulation changes, there are some hurdles to face such as the conservatism within the authorities after the so-called Tequila crash and the impact of 2008 on corporates.

The tequila crash – where a loosening of currency controls led to the peso crashing through the floor against the dollar and a \$50 billion loan guarantee intervention by the US – led to a tightening of banking control where banks had to reveal the measures they took for recapitalisation and the use of exotic derivatives. However, the tighter controls did not extend to corporate s

which were hit when the financial crisis happened.

"The authorities are very conservative and quite concerned [about derivatives]," explains Alegría. "After the 1995 financial crisis and meltdown, the financial sector was heavily affected and the authorities responded with a very heavy and strong regulation that worked. And in 2008 and 2009 the banks were pretty much untouched. Although they suffered, and business was slow, the balance sheets are very strong."

However, this was not the same for corporates which did some aggressive structure notes, basically trying to reuse their financing costs, interest rate swaps and some aggressive currency swaps with the Mexican peso and the Mexican interest rate tracking the US dollar. As a result, two or three very large corporations suffered heavy losses and at least two of them went bankrupt.

In addition, some private banking people and individuals also suffered losses from positioning and buying structured products. When the financial crisis occurred there were claims that they were not properly informed of the risks.

Alegría says that the reaction from the authorities was quite strong and that although their approach was "quite conservative", it was a case of lessons learnt.

International regulation is also having its presence felt among LatAm exchanges.

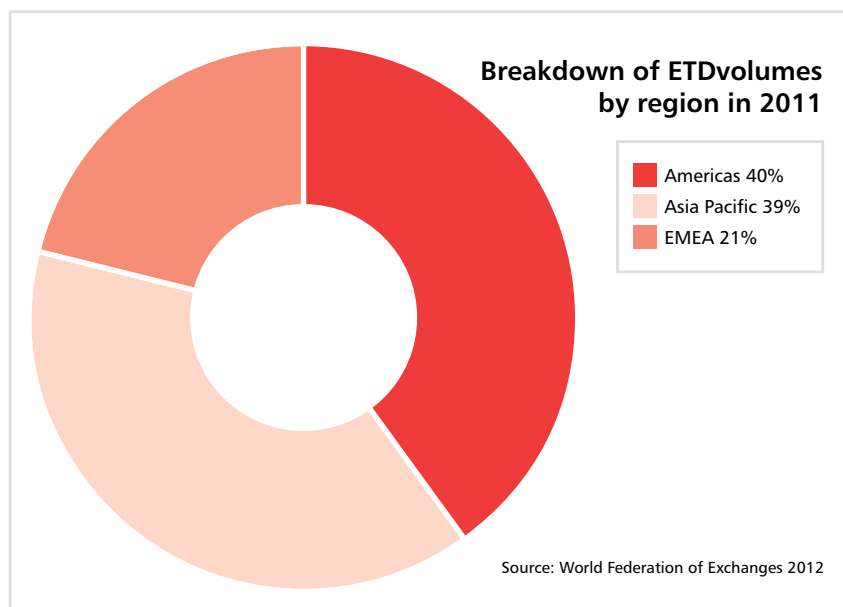
"As Mexico is chairing the G20 at the moment, it is clear what impact some of these regulations are having as regulators try to figure out the implementation of global regulation in terms of bringing transparency to the over-the-counter (OTC) markets," says Alegría.

**Number of ETD traded worldwide (billions of contracts)**

	Equity	Interest Rate	Commodity	Currency
2004:	6.1	2.2	0.6	-
2005:	6.9	2.5	0.7	-
2006:	7.7	3.2	1.0	0.3
2007:	10.9	3.9	1.3	0.5
2008:	11.6	3.2	1.2	0.6
2009:	12.1	2.5	2.3	1.0
2010:	13.8	3.2	2.9	2.5
2011:	15.7	3.5	2.8	3.1

Source: World Federation of Exchanges 2012





However, he adds that certain criteria present in the G20 communiques and the European and US regulations had already been put in place in LatAm countries.

Botis agrees: "Certain exchanges had things in place for a long time that we are only now looking to implement in the States. They have had a more cautious approach and they continue to have a cautious approach so I don't think global regulations have directly affected them."

She adds: "It is complementing them and reaffirming that what they have had in place for a while are the right things to have had."

Another hurdle that is being faced by emerging exchanges all over the world is technology. In South Africa for instance, the Johannesburg Exchange (JSE) cites technology as its biggest barrier to growth.

"Even if we double capacity, we are still behind other exchanges in terms of data and speed," says Leanne Parson, director of equity markets at JSE. "The technology infrastructure and the pipe size are things that needs increasing."

So with JSE, so with LatAm. However, the LatAm markets are increasing their investment in technology, aware of the need to compete with the speeds of New York, Chicago and London.

Botis comments: "I think all the Latin American exchanges have been doing an awful lot to upgrade their technology. Bovespa for example is introducing a new matching engine called Puma that they partnered with the Chicago Mercantile Exchange (CME) to employ. The Mexican exchange is bringing out a new matching engine later this year, and the Chilean stock exchange last year saw significant

changes to increase the throughput lower latency in their market as well."

"As the regulations change it is a relatively more expensive business to run compared to the OTC interdealer broker but it is important to invest in technology to attract that flow that is heavily growing in the OTC space and the customers you are trying to attract," says Alegria.

However, it is not just the exchanges that have to improve their technology. Brokers also have to increase their use of electronic trading.

"If you take the OTC market, there is strong resistance from the bankers to take that to an electronic market," says Alegria. "It is the way it has been done for the last ten years and there is resistance to change. And we need to break that."

"We are investing millions of dollars in technology to have a micro-second of timing in our trading engine. Investing millions in our clearing technology to have real-time risk management and the banks want to use the phone."

"From an exchange standpoint they've gone ahead and done their part, now it is up to the brokers to do their part," says Botis. "I think in the past, a lot of the brokers in LatAm have depended on exchange technology to trade and I think that now volumes are increasing, and there is a quest for lower latency, brokers themselves are now making investments to build out their own technology and differentiate themselves to their clients and internationally."

The last decade has seen mergers and acquisitions in the western exchanges as they positioning themselves in the

**“Certain exchanges had things in place for a long time that we are only now looking to implement in the States”**

**“It is much better to do it that way through a product alliance or a joint venture rather than a full M&A”**

global market and the oncoming global regulations.

However, in LatAm, it appears that partnerships and alliances are key to increase growth in the area and among international players.

In November, Chile, Columbia and Peru joined their exchanges together under the Integrated Latin American Market Agreement (MILA) which created the second largest LatAm bourse after Bovespa. The tying together of the security exchanges created a combined market capitalisation of nearly \$720 billion as of December 2011 and a daily volume of around \$300 million.

Chile currently has the largest participation in MILA with 48 per cent of all exchanges followed by 40 per cent from Columbia and 12 per cent from Peru. The alliance works by having complimentary investment niches such as Chile focusing on retail and services, Peru on mining and construction and Columbia on the financial and energy sectors.

In December, Mexico announced it was to join the alliance, which would almost double its size and is part of its on-going network of alliances.

"We have relationships in

Columbia, Chile, Peru, Ecuador and the Dominican Republic for example but not as an exchange but through such things as interdealer brokerships," says Alegría. "It is much better for us to do it that way through a product alliance or a joint venture rather than a full M&A at our size, especially going north or going east.

"Going South is an alternative and we are following that very closely and working very hard to be a part of MILA."

In addition, MexDer has an ongoing partnership with CME where the two exchanges have an equity stake in each other.

Meanwhile, Brazil has signed an alliance with Chile and is also part of a BRICS alliance that brings together Bovespa, MICEX from Russia, Hong Kong Exchanges and Clearing Limited and Johannesburg Stock Exchange (JSE) from South Africa while the National Stock Exchange of India and the BSE have signed letters of support and will join the alliance after finalising outstanding requirements.

At the first stage of this project the exchanges will begin cross-listing of financial derivatives on their benchmark equity indices. It is planned to launch

cross-listed products by June 2012.

"In addition to measuring market performance, equity indices may be used as underlying assets to create new products, which can be the next step in the alliance development," said Russell Loubser, CEO of the JSE at the launch.

"You see these exchanges joining to create a bigger force. So having that alliance does give them a competitive edge so you will see more inflow for example if someone in Mexico wanted to trade, they could go through the MILA route through Chile to get to Brazil," says Botis.

The growth rate of these exchanges appears to be hype, but it is a justified hype with growing middle classes, to educate and woo, and investment in commodities and technology.

"Is it justified hype?" asks Botis. "Yes, because there are good solid reasons for trading in the market and building up the infrastructure."

She adds: "So there is a risk in anything and a risk in investing in a new market. People are doing this in cautious, revenue-driven way. They are not just out there spending money or making investment because they think it's right. There is definitely something behind it."

Alegria adds: "Would we like to be the biggest exchange in LatAm? It would be nice. The way the Brazilian exchange grew was amazing and a great example of how to do things properly and how to take advantage of economic and political momentum." ●

**\$720** bn  
MILA market  
capitalisation



Thanks to the sovereign debt crisis, fixed income is no longer seen as a risk-free investment, writes Sally Percy

**T**here was a time when fixed income, particularly sovereign debt, was seen as a safe bet, the closest thing to a risk-free asset other than a house with its mortgage paid off.

And that time wasn't so long ago. In 2008, Greek 10-year bond yields were nearly on a par with German 10-year bond yields, with both hovering around the 5 per cent mark. Just four short years ago investors apparently believed that debt guaranteed by the Greek government was virtually as safe as that guaranteed by the German government. With hindsight, it seems a mad presumption. So how did it come to pass?

"When European yields were similar, the perception was that the European Monetary System was an unbreakable bond and the markets were all in it together," says Jeremy Cunningham, a senior portfolio manager at global asset management firm AllianceBernstein. "That perception was not accurate."

Since then, Greece has descended into bankruptcy, looked as if it would crash out of the euro and twice been rescued by its European partners (to the tune of €110 billion (£89.3 billion) in 2010, with a further hand-out this year of €130 billion). As part of the recent bailout deal, holders of Greek debt agreed to a 'haircut' that saw them suffer losses of up to 74 per cent as their existing bonds were converted into new, less valuable loans that paid lower interest rates. Passed off as a 'credit event', it was a default in all but name.

Unsurprisingly, Greek bonds have now assumed junk status and 10-year bond yields were 20.55 per cent by the start of May according to Trading Economics, although that's still a steep fall from their astonishing high of nearly 40 per cent earlier in the year, while German 10-year bonds return a measly yield of 1.7 per cent. The myth that the debt of any European country is as good as another's has been well and truly exploded. 'Risk-free' is a term that is used to mean an investment that is free of credit risk. But is the debt of any country, even Germany, ever 'risk-free'?

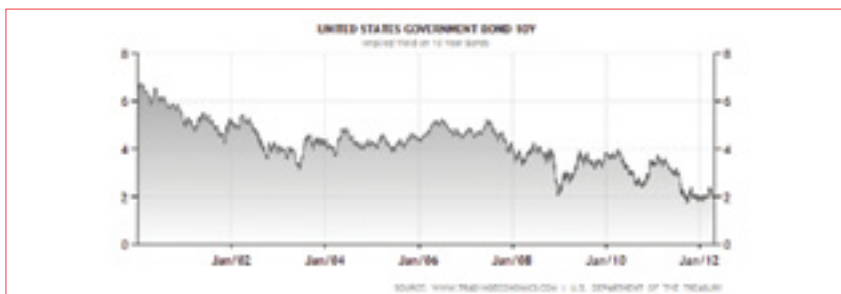
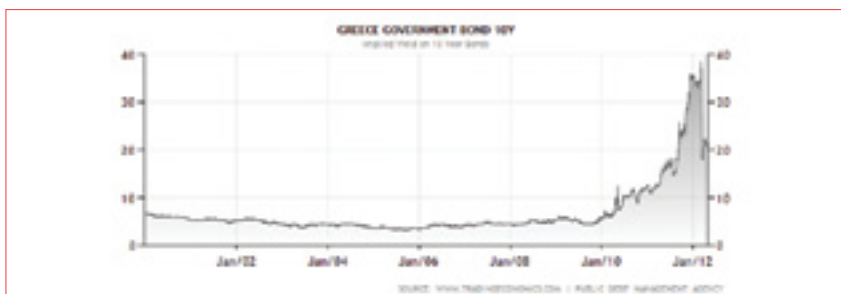
"Not all European sovereign debt is equal," observes Nick Gartside,

head of fixed income at JP Morgan Asset Management. "The market has discriminated. Germany has generationally low yield. Other places have generationally high yield. Countries that are perceived to be higher risk offer a higher reward."

"European sovereign debt can be trusted," says Nicola Marinelli, portfolio manager at Glendevon King Asset Management. "But we do not trust it right now. We think there could be more problems with Spain and Italy in the second half of the year."

## Pain in Spain

With the Greek crisis seemingly contained, at least in the short term, Spain has now emerged as the danger nation. The world's



**“When European yields were similar, the perception was that the European Monetary System was an unbreakable bond”**



## “The European sovereign debt crisis has now reached critical mass”

twelfth largest economy has a relatively modest government debt of 68.5 per cent of GDP, according to the European Union Statistics Office, but its private non-financial debt is a frightening 220 per cent of GDP and its banking system is on the brink of collapse after financing a real estate bubble that has since burst. House prices have fallen by over 20 per cent since 2007, the country has slipped back into recession and its unemployment rate is nearly 25 per cent. In the US, Spain has been described as ‘the Titanic of Europe’, the country that could sink us all.

On top of this, rating agency Standard & Poor’s (S&P) spooked the financial markets at the end of April by downgrading Spain’s debt by two notches, putting it on a BBB+ rating (‘adequate payment capacity’), only a few notches above a junk rating.

“The European sovereign debt crisis has now reached critical mass,” says Ranvir Singh, CEO of market analyst RANsquawk. “Spain’s banks appear completely reliant on emergency European Central Bank loans, and its government could soon be forced to pay unsustainably high yields on its bonds.”

Spanish bond yields were already nudging the psychologically critical 6 per cent mark prior to its credit downgrade and if they rise above 6 per cent for a sustained period over the coming months, Spain’s borrowing costs could accelerate to a level where it needs to be bailed out. The problem, though, is that Spain may be too big to bail out. So what will happen then?

It’s the multi-billion-euro question and nobody knows the answer.

### In good company

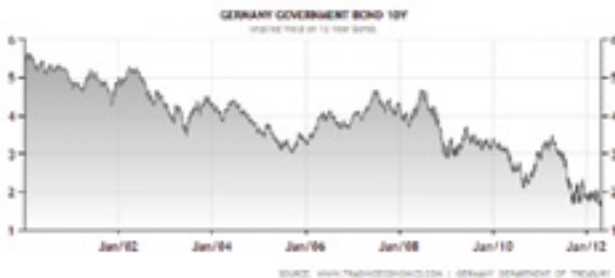
With sovereigns looking an unattractive investment prospect, either because the risk is too great or the yield is too low, many investors are turning to corporates. Non-financial companies in the US, Europe and Japan are sitting on an estimated cash pile of \$7.75 trillion (£4.78 trillion), according to global banking association the Institute for International Finance. It’s no wonder, then, given the abundance of cash-rich companies, that corporate bonds seem a more enticing prospect than government bonds right now.

Corporate bonds typically offer higher yield than government bonds (a bond issued by a FTSE 100 company, for example, is likely to have a yield of 2 per cent-3 per cent above a UK government gilt). But most corporate bonds are debentures, meaning they are not secured by collateral, and investors in those bonds must bear the risk that the issuer may default on its debt obligations, potentially to the extent that it virtually eliminates the value of the bond investment. Corporates also vary widely in their credit worthiness.

Still, the rewards appear to outweigh the risks. AllianceBernstein’s portfolio is now underweight in government bonds and overweight in corporates, according to Cunningham, with both investment grade and high-yield (also known as ‘junk’) bonds favoured. This is because the firm has carried out extensive credit analysis that suggests there will be relatively robust global growth in the foreseeable future, particularly in the US, Asia and northern Europe.

Marinelli says: “For financials [bank bonds] we still see scope for appreciation

**\$7.75trn**  
Non-financial  
companies' cashpile



in selected names and tiers. We see investment grade and high-yield as no longer cheap, but still fairly valued in terms of spreads and we think that high-yield in particular still has some room for price appreciation and carry [income return]."

"When you compare government balance sheets with companies' balance sheets, companies seem a better bet," acknowledges Gartside, but he emphasises that the fates of governments and companies are intertwined. If the government of a country is in financial trouble, it can drag down the companies based there.

"That linkage is very pronounced, certainly with bank bonds," says Gartside, adding: "Governments can tax companies as well."

The impact on institutions of a sovereign's rating downgrade is aptly demonstrated by Spain. On 30 April, S&P cut the credit ratings for 11 Spanish banks, including Banco Santander and Banco Bilbao Vizcaya Argentaria, citing 'potentially negative implications' from the nation's downgrade the previous week.

### Risk and reward

Despite the problems in countries such as Greece, Spain and Italy (Italian government debt is 120 per cent of GDP), fixed income is still seen as safer than most of the alternatives. "In very general terms, it's safer than equity," says Gartside, "because you are on a very different bit of the capital structure."

Overall, fixed income is performing strongly at present and this is set to continue. In fact, research by Bank of America Merrill Lynch revealed that in April

2012 fears over slowing global growth and financial contagion in Europe meant that bonds were the only investments to provide positive returns – for the first time since January 2008. Government bonds gained 0.57 per cent in April, including reinvested interest. Meanwhile, investment-grade corporate bonds gained 0.63 per cent and high-yield bonds grew 0.54 per cent.

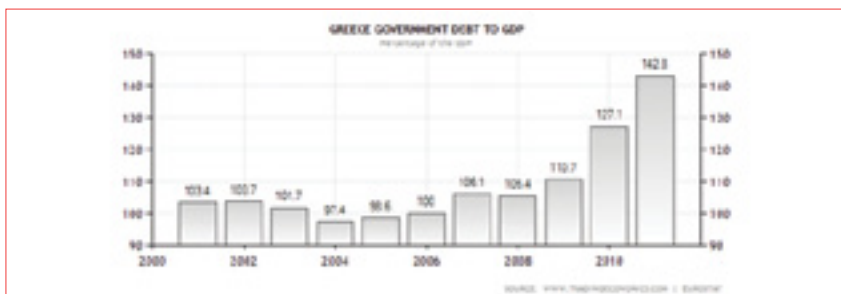
US treasuries and German bunds, in particular, are still seen as virtually risk-free investments, says Cunningham – even though Standard & Poor's downgraded the US credit rating by one notch to AA+ last August over budget deficit concerns.

"The US economy has its own printing press, which is more than you can say for the European market," he points out. "Despite the underlying fiscal problems in the US, it is still regarded as the safe haven

in the global fixed income market, along with Germany."

Risks exist, nevertheless, and these risks existed even before the financial crisis took hold. Interest rates and inflation have historically been the two main enemies of fixed income. If interest rates rise, the value of the bond in the open market will almost certainly go down while high inflation undermines the capital value of the investment. But there are other risks such as credit spread volatility (the risk that the difference in yield between government and corporate securities will widen), liquidity (the risk that an investor will not be able to find a buyer for the bond before it matures) and currency (the risk of loss on a foreign bond investment due to fluctuations in the exchange rate).

There is no 'one-size-fits-all' financial



**“The US economy has its own printing press, which is more than you can say for the European market”**

## “ Credit risk is seen as the biggest risk at the moment, and quite rightfully so ”

instrument for hedging the risks of fixed income. An interest rate swap with a bank, when a fixed-rate investment is converted into a floating-rate investment, can be used to hedge interest rate risk. A credit spread option protects against credit deterioration while currency forwards can be used to hedge currency risk. Liquidity risk can be managed by investing in more liquid assets, such as investment-grade bonds, and holding a diversified portfolio.

But now, with the sovereign debt crisis reigning, it is credit risk that is hogging the limelight.

“Credit risk is seen as the biggest risk at the moment, and quite rightfully so,” says Krishnan Iyengar, vice president global solutions at treasury and risk management software company Reval. “In Europe, most people are focusing on the fact they might

not get their principal back.”

Credit default swaps (CDSs) are typically used to hedge against the risk of a sovereign default. They can also be used to hedge against defaults by companies, banks and other financial institutions. In a credit default swap, the seller of the CDS, usually a bank, agrees to compensate the buyer with a specific percentage of the value of the bond once the issuer has defaulted. But CDSs have flaws. The

definition of a ‘default’ can vary; in the case of Greece there was much uncertainty around whether and when sellers of CDSs on Greek sovereign bonds would have to pay out to buyers.

Then, of course, credit default swaps themselves carry credit risks – as the financial crisis has shown.

“Entering into a credit default swap

contains inherent credit risk,” says Iyengar. “I might not know how many other agreements of that nature the bank has. For example, if the Spanish government did default, would the bank be able to pay?”

He points out that this is how American insurance giant AIG came unstuck in 2008, when it emerged in the early days of the financial crisis that it did not have enough money to pay out on all the CDSs it had sold.

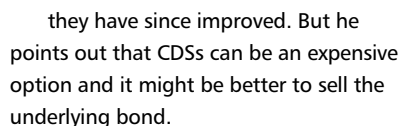
Iyengar also warns that it is important to consider bank counterparty risk when buying a CDS. “Doing a credit default swap within the country you’re trying to insure against would not be very prudent,” he observes.

Cunningham agrees that CDSs have been ‘stress-tested’ as a result of the crisis and says that it’s important to be careful when using them, even though

**3.80%**  
Australian 10-year yield







So fixed income is still fairly safe, but is it safe enough? And what does the future

Gartside says that besides the obvious safe havens of the US and Germany, Canada, Australia and the Nordic companies all offer some of the safest debt in the world. He says that Australia, in particular, offers a good risk-reward ratio since the yield for a 10-year bond is

So the only thing that's certain is there will be more uncertainty in fixed income for the foreseeable future. And while there may be no such thing as a safe bet, some bets are safer than others. ●

**SALLY PERCY**, Journalist>>>>>>>>>>>>>>

**“As a bond investor, you have to do your homework. You have to get your hands dirty”**

# CIR | Risk Management

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# Credit where it's due >>>>>>>>>>

Four years into the downturn, credit risk is increasingly an issue with smaller businesses bearing the brunt writes **Graham Buck**

**F**ive years on from the first intimations of the credit crunch, the focus of the financial crisis has steadily moved from liquidity risk to credit risk. Last month the financial markets shifted their attention from Greece and Portugal to Spain, as the growing prospect of a crisis in the country's banking sector pushed the cost of insuring against Spanish default to record levels.

Elsewhere in Europe indicators of corporate credit risk moved higher as voters in France and Greece opted for political parties opposed to austerity.

Other ominous pointers to a period of further turbulence included a Wall Street Journal analysis of Europe's ten largest banks, suggesting that the eurozone's seemingly intractable problems have persuaded them to move more of their cash to central banks. The paper found that the 'Big 10' had total cash of nearly \$1.2 trillion (£0.74 trillion) deposited with central banks around the world at the end of March; a \$128 billion or 12 per cent increase from the end of December and a 66 per cent rise from the end of 2010. The move enables them to access funds more easily if faced with an emergency.

The report will have made disappointing reading for the European Central Bank (ECB), suggesting that much of the increase was derived from the \$1 trillion of cheap three-year loans that the ECB made available to banks late last year. The intention was that this money would encourage them to start lending more to

companies, not that they would squirrel it away.

Another growing concern is that a prolonged economic crisis in Europe will result in tighter credit conditions extending to the rest of the world and undermine the efforts of major companies attempting to raise funding through bond sales.

Ratings agency Standard & Poor's (S&P) has issued an alarming report apparently predicting that non-financial corporations in the UK and the eurozone, the US, China and Japan will seek to raise between \$43 trillion and \$46 trillion over the next five years; comprising \$30 trillion of debt to refinance existing bonds and \$13-\$16 trillion of new money to fund growth.

"Combined with the eurozone crisis, the slow US economic recovery, and the prospect of a slowing economy in China,

this raises the downside of a perfect storm in global corporate credit markets," says Jayan Dhru, S&P's head of global corporate ratings.

As the report notes, the demand for funds will come at a time when credit rationing may intensify as banks attempt to restructure their balance sheets while bond and equity investors reassess their risk-return thresholds.

Although this potential scenario is alarming, many medium-sized and large companies have amassed sizeable cash piles in recent years. Indeed, closer reading of the report shows S&P to be confident that the majority of non-financial corporate debt issuers will successfully manage their refinancings between now and 2017, although new term bank financing to fund growth is likely to be scarcer. What threatens to

**New Nonfinancial Corporate Money Demands 2012-2016**

Region	Nominal GDP growth assumption (2012-2016)*	New money requirements (US\$ bil.)	
		1x**	1.2x†‡
Euro area	3%	1,555,771	1,889,452
U.K.	4%	355,398	433,349
U.S. (including mortgages)	4%	2,494,802	3,042,002
China	12%	7,695,839	9,685,463
Japan	2%	773,633	935,814
<b>Total</b>		<b>12,875,443</b>	<b>15,986,079</b>

\*Assumptions are adjusted for inflation and the Consumer Price Index, and are derived from forecasts in our sovereign reports on France, Germany, the U.K., the U.S., China, and Japan. \*\*Assumes debt grows at same rate as GDP over the next five years. †Assumes debt grows at 1.2x the rate of GDP over the next five years. Source: S&P

**“The demand for funds will come at a time when credit rationing may intensify as banks attempt to restructure their balance sheets”**



## “So far, deleveraging has occurred predominantly through buttressing capital positions”

produce deeper problems is the limited fiscal and monetary flexibility now available to governments and central banks to calm turbulence from future market disturbances.

### Corporate zombies

In the UK the corporate insolvency rate has already begun to edge higher as the economy subsides back into recession. The first quarter of 2012 saw just over 4,300 companies liquidated in England and Wales; a 0.2 per cent increase on the previous three months and 4.3 per cent more than the same period last year according to the Insolvency Service.

A sign of the times is that controversial payday lender Wonga has detected opportunity in the difficulties faced by smaller businesses. Last month it added an 'instant' loans service for SMEs to its online lending to consumers. Promoted as being for businesses experiencing immediate cash flow problems rather than those seeking long-term credit, the service is open to businesses established for a minimum of three years and with monthly sales in excess of £20,000.

General reaction to the Q1 figures was that although they reflected the problems being experienced by individual sectors such as retail and construction they still masked the financial struggles experienced by many businesses. As David Birne, an insolvency partner at accountancy firm HW Fisher comments: "There are still thousands of 'zombie' companies which are stumbling on, as banks are reluctant to push all but the basket cases into insolvency.

"Banks are showing remarkable levels of forbearance – sometimes even with

the firms that are dead from the neck up – and with little prospect of clearing all their debts."

A downbeat report last month from Ernst & Young ITEM Club suggests businesses that have so far concealed their financial troubles have done no more than secure a brief respite. Its latest outlook for financial services warns that lenders should brace themselves for the highest level of defaults in 20 years.

The ITEM Club forecasts that write-offs will rise to 1.9 per cent of loans made to the corporate sector this year against 1.6 per cent in 2011, with the North East of England and Wales likely to suffer the sharpest increases.

Until now the economic downturn of 2008-2012 has proved more benign than that of the early Nineties says Max Firth, managing director of Experian Business Information Services.

"The rate of corporate insolvencies then tripled or even quadrupled; this time around it has, at most, only doubled. The peak was in early 2009, when it was similar to the rate experienced in the aftermath of the dotcom boom to bust."

With SMEs already finding it hard to obtain credit, the company insolvency level is likely to return towards that level over the coming months. The ITEM Club has pencilled in a figure of £419 billion for lending by UK banks in 2012; a 6.8 per cent decrease on last year and even further below the 2008 peak of £575 billion. Corporate sector loans are not expected to return to this pre-crisis level earlier than 2016. Neil Blake, senior economic adviser to the club warns that the funding squeeze already being

experienced by corporates and SMEs is very likely to intensify in the meantime.

Business recovery specialist R3, which publishes a monthly business distress index, reports that the number of companies regularly utilising their maximum overdraft facility has nearly doubled in recent months.

"This shows just how many businesses are really struggling out there, but are not part of the insolvency service statistics," comments Lee Manning, R3's president and also a partner at Deloitte.

"The statistics do tell us however that we have not had the spike in corporate insolvencies that tend to follow a recession, as asset values rise and creditors act on failing businesses. We are living in a different world to previous recessions, when creditors were much more 'trigger happy'."

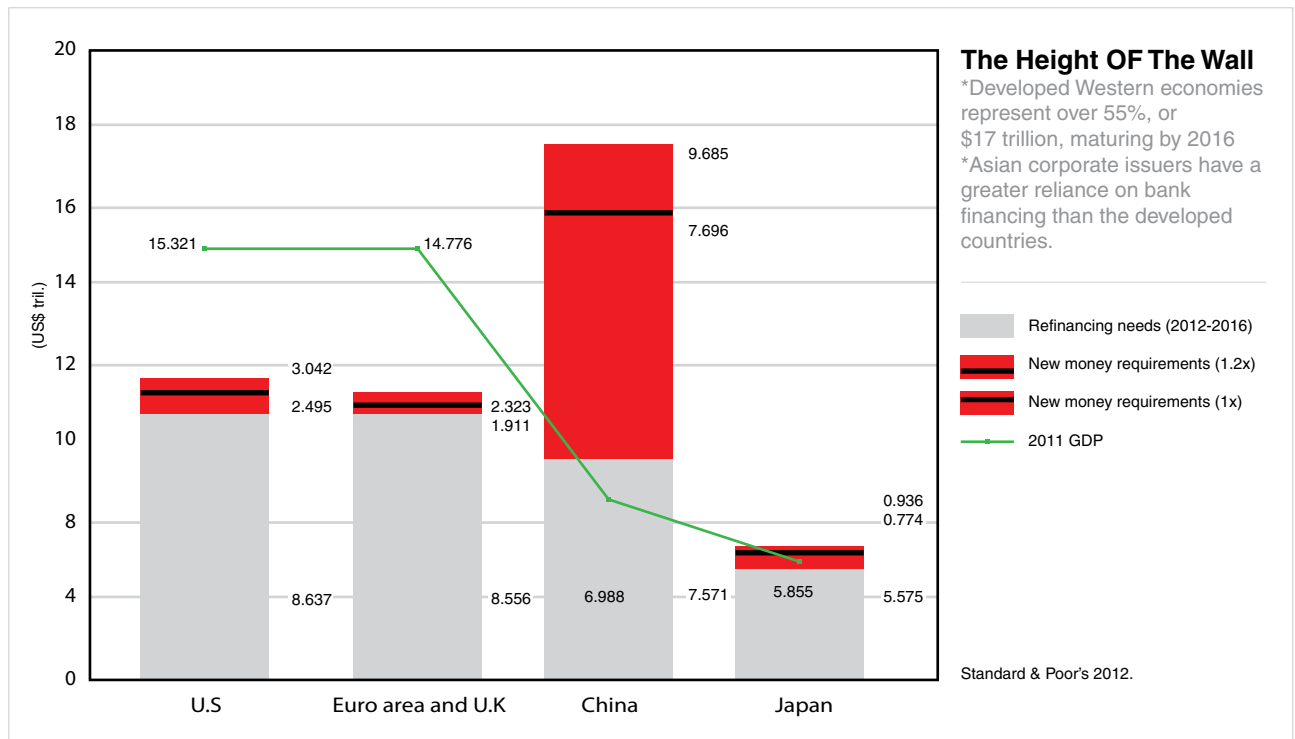
**£419 bn**  
Estimated lending by UK banks 2012

### Plugging the gap

Europe's businesses can expect to see the bank sector's risk averseness to continue. The International Monetary Fund (IMF) warned in its latest global financial stability report issued in April that European banks could collectively sell between \$2.6 trillion and \$3.8 trillion of assets in 2013.

"So far, deleveraging has occurred predominantly through buttressing capital positions and reducing non-core activities, leaving the impact on the rest of the world manageable," noted the IMF.

"It is essential to continue to avoid a synchronised, large-scale and aggressive trimming of balance sheets that could do serious damage to asset prices, credit supply, and economic activity



in Europe and beyond.”

With banks under increasing pressure to reduce their risk exposures and strengthen their capital reserves, a funding shortfall is likely to intensify unless access to non-bank finance is improved.

A government-backed task force headed by Tim Breedon, chairman of the Association of British Insurers and group chief executive of Legal & General, issued its report in March that warned of a UK ‘credit gap’ of between £84 billion and £191 billion developing between banks and businesses over the next five years.

The Breedon report notes that mid-sized firms in the US are much better

positioned than their UK counterparts to issue private placements, and offers various recommendations for plugging the UK business funding gap. They include the establishment by industry of a business finance advice network that uses the main accountancy bodies, and setting up an agency to aggregate small business loans that either lends directly or parcels up loans to provide indirect access to the corporate bond markets for small companies.

Firth says that there are already signs of a shift away from traditional lending, although not necessarily away from the banks: “Invoice financing has proved to be an efficient form of finance, although

one that is still not widely known about.”

He continues: “SMEs that secure deals with major companies must take into account the fact that they typically take their time to pay. They need to educate themselves on how best to look after their credit rating and interact with major customers. They also need to understand the implications when a customer proves slow in paying.

“The SME market is one that Experian is particularly interested in. We want them to understand credit scores and credit reports. If your company is late in submitting accounts, then it will be affected. Large companies can and do check their suppliers and carry out credit ratings.”

**“SMEs that secure deals with major companies must take into account the fact that they typically take their time to pay”**

## “

**GRAHAM BUCK, Contributor** >>>>>>>>>>



# No raffle on Singapore's future

*Financial Risks Today* talks to SGX president **Muthukrishnan Ramaswami** about the risks and issues surrounding the exchange in the light of greater international regulation and mergers

**T**he Singapore Exchange (SGX) was formed on 1 December 1999 out of the Stock Exchange of Singapore, Singapore International Monetary Exchange and Securities Clearing and Computer Services and was the second exchange in Asia-Pacific to be listed by a public offer and private placement. It styles itself as the gateway to Asia with most Asian

markets offered through the exchange with Indonesian futures the latest to be offered on the exchange in mid-June this year.

It claims to be the continent's most internationalised exchange with more than 40 per cent of companies listed there originating outside of Singapore and, since its formation, has grown to offer 769 listed companies with a market cap of SGD\$861 billion (£435 billion).

SGX president Muthukrishnan Ramaswami says that it operates a series of what it call "verticals" which operate under a single commercial exchange.

"We have a trading entity, a clearing entity and a depository that is on the securities side, and a similar set-up on the derivatives side where we have a trading entity and a clearing entity," says Ramaswami.

He continues: "What we can offer any



**“The risk mitigation that we provide is much more transparent and predictable and is also strongly funded”**

player in the futures and securities market is the ability both to manage the risks across Asia in one location or in another way trade Asia from one location and cover many of the markets."

As a result, SGX offers a sectorial approach and a country perspective.

Ramaswami comments: "If you take plantations, we have plantation companies from Malaysia, from Indonesia, who list with us and that's a sector that is pretty strong and robust. Similarly, if you take shipping, Singapore has a long maritime history and around that we also have companies that serve the shipping industry be that port operators, ship builders,

ship breakers, so we have companies from as far away as Oslo in that context."

However, this brings its own challenges surrounding risk mitigation, in particular in its clearing areas with investors becoming increasingly concerned about risks associated with countries or, indeed clearing houses.

SGX finds that there has been higher growth in the open interest maintained in its clearing house and has seen its open interest in the Chinese A50 futures market reach 12 per cent which it clears every day.

It is a similar tale in India, according to Ramaswami, where trades contribute around

25 per cent of the market currently although having with a 35 per cent of the open interest.

"What that says is that the risk mitigation that we provide is much more transparent and predictable and is also strongly funded and is on very stable ground in terms of the capital that we bring to our clearing house; the mark to market processes that we use, and the margin calls that we use and so on."

Ramaswami says that SGX has been trying to expand its capabilities to supporting OTC instruments particular in the commodities sector, as Asia is not only a large consumer of commodities but is also a producer and active derivatives user.

SGX has also built capabilities in clearing OTC financial derivatives.

"So we wanted to build the infrastructure that supports the interest rate swaps that we deal with in Singapore and the region, so that the global banks that operate in our markets are not constrained in terms of access to clearing facilities and therefore having to put too much capital or having to curtail businesses."

Like exchanges around the world, SGX has to contend with a raft of regulations stemming from not only the international standard of Basel III but also from US and European regulators.

With its long tie-up with the Chicago Mercantile Exchange and having been a recognised overseas clearing house from both a US and European perspective, SGX believes it has a long-standing ability to comply and cope with upcoming regulation.

However, with the Dodd-Frank rules

**£435<sup>bn</sup>**  
SGX's market cap



**Derivatives Overall Market Volume**

	Feb 2012	Mar 2012	Apr 2012
Total Futures Trading Volume	6,265,634	7,206,216	6,036,489
Total Options Trading Volume	300,716	342,405	242,748
Total Futures & Options Trading Volume	6,566,350	7,548,621	6,279,237
Futures & Options Average Daily Trading Volume	323,058	353,683	322,213

1. Include Metal, Robusta Coffee and Rubber Futures.

2. Futures & Options Trading Volume represents the number of contracts traded.

Source: SGX

starting to come in, Ramaswami warns that there is uncertainty about whether the old recognition of a designated clearing operation will still continue or whether there will have to be a new application to get recognised under new rules.

He continues: "So in dealing with those it means a lot of paper work but on top of that there are some issues such as; which regulator takes precedence in the kind of issues that do pop up and issues that are still unknown?"

"I don't think there is as yet clarity on how anyone works with two equally primary regulators. By an historical nature we have always had a primary regulator, and then we work in line with the requirement of any other regulator."

Even though he believes that every regulator wants primary access, and he hopes there will be an alignment of outcomes eventually, Ramaswami is fairly confident and comfortable that SGX will be able to continue to serve its US customer base, especially when it comes to capital requirements.

SGX went through the Financial

Sector Assessment programme in 2005 and it believes that it will be the first to go through the assessment using the 2011 guidelines as set out by Basel III using its regulators which Ramaswami believes is "a high watermark in being prudent and consistent".

He adds: "If you take capital as an example; we provide enough capital in our clearing funds that any exposure to SGX qualify for the lowest tier of the standards and under Basel III you will only

have to mark 1.6 per cent or 1.8 per cent of capital for exposure to SGX compared to higher ranges of up to 120 per cent in other clearing houses. So we have taken a conservative route to say that we will comply, in terms of being well provided for capital and in terms of being adherent to all the terms and principles that are laid out."

In Europe and the US, there has been a steady run at takeovers and mergers among exchanges but Ramaswami believes that for SGX's primary Asia clients there isn't the same appetite for mergers.

"The way we see it from a participant perspective is that we look at it from an end-user point of view. If you take an average Asian customer they would like to keep their risks and banking relationships in their daytime, in their time zone and they don't want to particularly be sitting here operating a margin call from CME late at night and so they would like to move to an Asian clearing house as much as possible."

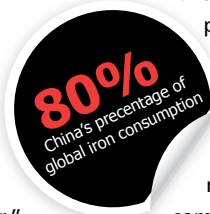
For the exchange, it is not that connectivity and the portability of risk is being ignored, for SGX the key is to make this connectivity stable and longstanding.

"We do have experience building these but we also don't see ourselves sitting here in Asia buying or operating an exchange in New York or London – outside our time zone, outside our particular area of expertise – so we of course prefer the area of connectivity as against the purchase, if you will, that you see in the Western world."

In addition, Ramaswami doesn't see one particular clearing house becoming globally dominant, but asset class dominant, citing interest rate swaps being dominantly cleared by LCH while SGX could become the global leader in iron ore for example.

Ramaswami adds: "The way I see it is that we don't need to be dominant or number one in every asset class or be the single largest intergalactic clearing house. You must bring specific expertise and specific markets in yourself for reasons that are logical and underpinned by economic and physical realities.

"It's the nature of the consumer and the producer so if you take iron ore for



**“I don't think there is as yet clarity on how anyone works with two equally primary regulators”**

“

	March 2012	April 2012
Number of Trading Days (Securities)	22	20
Securities market Turnover Volume (million shares)	36,857	64,348
Securities market Turnover Value (\$million)	28,795	23,534
Securities Daily Average (\$million)	1,309	1,177
Derivatives Volume	7,548,621	6,279,237
Derivatives Daily Average Volume	353,683	322,213
Total Number of Listed Securities	768	769
Total Market Capitalisation (\$million)	870.865	861.275

Source: SGX

example, 80 per cent was consumed in China in the last five years and a lot of it is mined in Australia so are they going to go all the way to London to clear this and come back? The answer is no. Singapore is a nice neutral territory to clear this. We don't have a producer or consumer bias" Currently, about 90 per cent of cleared iron ore swaps are cleared on SGX.

This May saw the anniversary of the flash crash and, like other exchanges, SGX has low latency with Ramaswami claiming that the exchange has one of the fastest securities trading engines in the world.

While, acknowledging that there

are fears surrounding low latency with respect to high frequency trading, Ramaswami considers the issue of speed itself as overblown: "It needs to be in-line with what is happening in the world and when people ask about the unfairness in speed, if you go back to the days when you had trading pits, the tall trader always had an advantage.

He continues: "It is good to have speed but that is not the issue, rather it is the number of trading venues that you have and what each trading venue does; i.e. fragmentation. Also important is what sort of safeguards an exchange has when the market becomes volatile.

"In our context, we don't have that many trading venues to execute our stocks or futures on. At the same time, our preventive measures are robust. We introduced pre-trade risk controls in April so that the clearing member is able to set a limit in terms of risks that any of their trading members can take."

As a result, with the clearing member setting the limit you never run out of control, "and it is the same for everyone so there is no latency difference between

trader 'a' and trader 'b' because both of them have to go through the same pre-trade risk control".

Aside from international regulation, the one thing that Ramaswami finds will be vital in the near future is uniformity in regulation across Asia. He believes that it is necessary to avoid a “very fragmented marketplace” across the region.

"I think our regulators are beginning to take this into account and we have had lots of consultations across Asia on this so it is work in progress," he adds.

Finally, Ramaswami warns that for Asia as a whole, there is a huge amount of financing needed to be found as there are cities that need to be developed, or transportation or general infrastructure for areas where populations exceed 100 million. For this to happen, the development of the bond market and the development of private/public ownership needs to happen to make things grow.

However, he says, these developments can get “bogged down by the regulation quagmire” between US and Europe which in turns influences and feeds regulation in Asia.

"If those things are in a stalemate or an acrimonious debate, progress here will get stalled and the consequences will be unattended. That is a worry because we do think the markets need to develop more rapidly. Regardless of the myth around decoupling, I think Asia is too small and the entrenched financial marketplace that are in the US and Europe are way too big for Asia to peel off and act independently. ●

**SIMON MILLER**, Editor >>>>>>>>>>>>>>





# Factoring in the bribery risks

With the Bribery Act coming into force, CEO of the Red Flag Group Scott Lane sets out what investment banks should be aware of when developing their control systems for the Act

**T**he investment banking industry in the United Kingdom has recently attracted the close attention of the Financial Services Authority (FSA).

During a five-month assessment of compliance and governance structures across the sector, firms were scrutinised on their ability to minimise the risks posed by bribery and corruption. Considered to be an industry that is highly susceptible to such risks given its reputation for lavish hospitality practices, generous remuneration structures and frequent engagement with third parties, firms are now under greater pressure to foster a culture that not only promotes an ethical business environment but also ensures that the appropriate governance is in place to mitigate any risk. But what are the key factors that companies registered under the FSA should be aware of when developing and revising their anti-bribery and corruption control?

## Background

In March 2012, the FSA published a consultation report entitled *Anti-bribery and corruption systems and controls in investment banks*. The purpose of the report was to provide a detailed analysis of how investment banks in the United Kingdom are managing bribery and corruption risk in their business. In compiling the report, the FSA conducted visits to 15 firms, which included eight

global investment banks as well as some small and mid-size operations. Most of the 15 firms reviewed were considered to conduct business within countries, with industries, or with clients, that exposed them to higher levels of bribery and corruption risk. Whilst the report relates specifically to the investment banking sector, the authority insists that many of the examples it provides may be relevant to a number of firms in other areas that are subject to the FSA's rules.

The report sets out the details of the FSA's findings and observations under a number of topics which relate to anti-bribery and corruption (ABC). Five of the key topics analysed include (but are not limited to):

- governance and management information
- bribery and corruption risk assessment
- policies and procedures
- third party relationships and due diligence
- gifts and hospitality.

The report also provides many examples of good and poor practice under each of these topics.

## Summary of observations

Throughout their report, the FSA expressed their concern that the investment banking sector had been too slow and reactive in its management of bribery and corruption risk, with

most firms only implementing significant changes to their policies after the Bribery Act 2010 came into effect in April 2010.

Overall, the regulator's opinion was that the investment banking sector still had "significant work" to do to get adequate control frameworks in place. However, it was acknowledged that progress had been made by firms in terms of their identification, or reassessment, of potential bribery or corruption risks and factoring them into their policies, procedures, training



**“The investment banking sector still had ‘significant work’ to get adequate control frameworks in place”**

and monitoring.

### Key findings and recommendations

The following items set out some of the key warnings issued by the FSA that the investment banking sector should be aware of, as well as some of the crucial ways of improving ABC controls.

### Governance and management information

The FSA is of the expectation that any senior manager in a firm should fully understand the bribery and corruption risk faced by the firm, the materiality of the risks to its business and the extent to which a firm's ABC controls are adequate and effective. To achieve this, firms must produce detailed and accurate management information in order to assist boards in understanding these issues, helping decision makers to

deliver effective solutions in mitigating risk. The FSA also recommends that, where relevant, this management information should include information about third parties (including new third party accounts, their risk classification and even any commissions paid). Failing to establish an effective governance framework to assess bribery and corruption risk is considered to be poor practice by the FSA, and an area that should be addressed by all in the industry.

As a result, companies address this by ensuring that:

- there is a sole person responsible for the development and implementation of the ABC compliance programme (the ABC Programme Leader)
- the ABC Programme Leader has experience in a recognised compliance standard (for example Australian Standard AS3806, a leading compliance

standard recognised globally)

- the ABC Programme Leader has led the awareness of the ABC programme throughout the organisation through regular communication with all senior and middle management, and this communication has been documented as part of an overall communications programme.

### Bribery and corruption risk assessment

According to the FSA, a prerequisite to an effective risk control framework is an accurate and comprehensive assessment of bribery and corruption risk. In its review, the FSA gave consideration to the extent to which a firm's processes enabled them to identify bribery and corruption risks specific to their business, and assess the material relevance of these risks to the firm. Risk factors identified by various firms include (but are not limited to):

- client/project type
- country risk
- sector risk
- involvement with public bodies
- business activities
- involvement with third parties
- various internal processes such as remuneration and gifts and entertainment activity.

A cause for concern to the FSA was the timing and frequency of risk assessments conducted by firms. In many cases, a risk assessment had only been performed to coincide with the commencement of the Act. Of equal concern to the FSA was that many firms had not consulted external experts in



performing their assessments. It was highlighted that where an external party is engaged, they must demonstrate sufficient anti-bribery and corruption expertise as opposed to generic external guidance. The FSA recommends that the responsibility of undertaking a risk assessment and keeping findings up to date should be assigned to individuals with sufficient expertise, and that external parties should be consulted where appropriate.

It is recommended that an ABC risk assessment:

- is done at least quarterly in high risk areas of the business, and at least bi-annually in all other areas
- is not limited to questionnaires or surveys but includes face-to-face discussions with senior and middle management, visits to international offices (particularly those in emerging markets), conducting of workshops, business process walkthroughs of the business engagement with government, government facing third parties, and industry peers
- includes an assessment of emerging risks which have arisen due to changes in the business, development of new products, launch into new markets, new regulations, new enforcement activity by regulators and expectations of

stakeholders including customers

- is conducted in conjunction with external advisors, or, at the very least the design of the risk assessment is reviewed by external experts to ensure completeness, overall coverage and depth
- is reviewed by the compliance office, executive management and reported out to the board or a risk and compliance committee of the board.

### Policies and procedures

Preventing bribery and corruption risks from crystallising is of paramount concern to the FSA. The implementation of robust ABC policies counteracts this crystallisation, and should cover the key areas such as expected standards of behaviour, escalation processes, conflicts of interest, gifts and hospitality, and the engagement of third parties. Frequent review of these policies and procedures is essential, and they should reflect risks to the firm proportionately. The FSA also highlights the importance of having clearly defined processes in place for dealing with breaches of firm policy, and having the mechanisms handling reports of suspect behaviour.

With regard to policies and procedures, we recommended that:

- they are written in plain language and are short, practical and are full of examples
- they should be available in all languages which are the primary languages spoken in the countries in which the company operates
- they are available on the company's intranet and linked to all employees through a web-based tool available on

mobile devices

- they always include escalation points that identify exceptions to the policies, and there is a procedure to document such exception approvals
- implementations of the policies are accompanied with a communications plan that reaches all levels of the organisation
- implementation of training is specific to the policy and procedure (not the law) and that training be specifically designed for the company and not standard "off-the-shelf" training on the Act. The training should be targeted to specific groups of the organisation and should be customised to work areas and roles
- they are coupled with a focus on changing the underlying behaviour of the people to whom the policy addresses. Simply promulgating a policy and procedure is not sufficient – the underlying behaviour and motivators to change have to be considered.

### Third party relationships and due diligence

Given the very broad definition of an "associated person" in the Act, there is an extremely wide ambit as to whom a firm might be considered to have corrupt dealings with. This can include consultants, lawyers, contractors or any intermediaries. As such, the FSA expects firms to have policies and procedures that provide a means of assessing the risk of retaining particular third parties, and adopt measures to mitigate that risk accordingly. This can include the categorisation and business use of third parties and establishing a definitive list

## “Any external relationship used to generate business should be subject to thorough due diligence”

of third parties who would be considered “associated persons” in accordance with the Act. A recommended practice is for firms to identify and understand the risk factors associated with engaging a third party, and have clearly documented procedures for taking on new third party relationships. Monitoring and reviewing third party relationships, as well as testing the quality of due diligence performed, are also considered to be essential practices of any investment banking firm. As a basic principal, any external relationship used to generate business should be subject to thorough due diligence and management oversight.

The Red Flag Group recommends that:

- a study be conducted of all third parties that are engaged by the firm, both at home and abroad
- the third parties are categorised into how they engage with their government and at what levels and how they may act as an influencer in transactions that are non-government
- the firm build a third party compliance programme around the third parties that manages the risks that they pose to the firm, and which is not limited to due diligence, but includes a range of measures and changes that manage the complete cycle of the third party from on-boarding through to termination or closure
- any payments made to these third parties are subject to additional controls, for those that are engaging with government on the firm’s behalf or working with state-owned enterprises. These third parties may have restrictions

placed on them regarding purchase order controls, restrictions on access to special funds for reimbursement of expenses, and additional layers of signoff on invoices

- the third parties may be subject to additional measures including review, audit, face-to-face training, additional contractual methods or audits, based on the level of risk and the work that they are doing for the firm.

### Gifts and hospitality

Whilst it is acknowledged that the exchange of gifts can serve legitimate business purposes, this is an area where the line between *bona fide* business practices and corrupt behaviour can easily be blurred. The FSA observed that many investment banks are trying to implement cultural change to shed the image of bygone days of lavish hospitality in the industry. In order to alleviate any bribery or corruption risks, measures taken by firms which the watchdog considered to be good practice include:

- prohibiting cash (or cash-equivalent) gifts
- not issuing corporate credit cards
- prohibiting invitations to certain clients to premier events
- prohibiting the flying of clients to major events.

In incidents of significant expenditure, firms should be implementing a system whereby employees demonstrate an appropriate business case to justify such activities, with a clearly defined approval mechanism through senior management. In light of these suggested measures, maintaining a handle on all gift and

hospitality activities will be very difficult, particularly for widespread international firms. Compliance officers will effectively need to:

- monitor and assess all gift and hospitality requests with high frequency and give approval with great expediency
- keep accurate and accessible records of corporate sponsorships or donations
- continually upgrade policies to coincide with shifting business interests
- be capable of reviewing and approving requests in multiple languages
- store and track large amounts of data to effectively keep abreast of all gift and entertainment activity in a firm.

Gift and entertainment policies should address at least the following issues:

- an expense limit per gift or entertainment per person, per recipient person (or company), per year
- limits are designed to not allow staff to give multiple “small gifts” to fall below the policy limit
- expenses for gifts and entertainment are subject to pre-approvals before the expense is incurred and such pre-approval is given and maintained in an online searchable database
- pre-approvals should include line management as well as a “fiduciary” such as finance
- the actual expense is mapped back to the pre-approval system
- such expense approvals are monitored closely with exception reporting, spike analysis and quarterly auditing. ●

SCOTT LANE, Red Flag Group >>>>>>>>>>







been a drive within the city to encourage staff to speak up and so the need for independent advice by their staff has lessened? No wrongdoing taking place? With the news this month of the extraordinary losses at JP Morgan which followed UBS, Credit Agricole and many others, I think not. Or, most worryingly - has there been a clampdown on confidentiality within the financial world? What is the reality of the situation?

Confidentiality is clearly an essential principle for all to understand in the City, and it is an especially important factor in the Financial Services and Markets Act 2000 (FSMA), but likewise it is essential that firms can demonstrate that where there is wrongdoing or malpractice, the cloak of confidentiality is not used to hide matters of public interest.

Much of this is a balancing act. Workers are often the first to see that something is wrong and yet they may risk their livelihoods in raising the issue and often work under obligations of secrecy. How do we ensure that corporate cultures in which dissent is crushed are effectively challenged? And how do the 'good' corporate cultures stand out from the crowd?

These questions lie at the heart of what we do here at Public Concern at Work. Providing advice to workers to help them challenge such cultures, but at the same time helping organisations to meet the challenges of these sometimes competing interests. Enlightened organisations recognise that it is in their own self-interest to encourage their staff to speak up and question ethically troubling decisions as well as the outright wrong or corrupt. Staff

questioning matters should be central to all compliance systems. While formal compliance is all very well (Enron had a 'best in class' whistleblowing policy), this must be coupled by a desire to challenge the informal culture. This is critical if things are to change. This was illustrated by the very public questioning of the culture at Goldman Sachs by former director Greg Smith who said he was leaving because the culture which used to revolve around "teamwork, integrity, a spirit of humility, and always doing right by our clients" had "all but disappeared".

I do not underestimate the challenge that this will mean for those working in the compliance world. The tick box mentality is not enough. Putting ethics at the heart of every business decision trips off the tongue, but is difficult to achieve practice. A good starting point is to put your whistleblowing arrangements to the test. Looking to see whether staff have trust and confidence in the arrangements is key to this and proving to your staff that you live by what you say and that it works in practice. If, on the other hand your whistleblowing arrangements present your staff with a cardboard shield that will be the quickest way to ensure that a culture of silence pervades throughout.

Regulation is also undoubtedly part of the answer and only this month the FSA's interim director of enforcement and financial crime Tracey McDermott said that its more 'muscular' regulatory approach is here to stay. Evidenced by a more intrusive approach to supervision which challenges the assumptions made by those it regulates and coupled with more enforcement work.

The newly enacted Dodd Frank Act means that in the US a whistleblower is given a cut of the damages or fines recovered for the wrongdoing – if this is pursued and proved by the US regulatory bodies or the government. Rewarding greed with greed you might say. This is to be distinguished from the approach in the UK where our whistleblower law, the Public Interest Disclosure Act, looks to protect those who raise concerns about serious risk, wrongdoing or malpractice in the workplace and provides a remedy in damages if an organisation dismisses or victimises a worker for having raised a concern. When enacted it was seen as a new approach, giving the individual a robust legal safety net while at the same time promoting responsibility and accountability. It was praised by Lord Nolan for achieving the "essential but delicate balance between the public interest and the interest of employers". We would like to see the legislation reviewed and better championed by this government, but that is for an entirely different article. It's about time that the 'wilful blindness' where the delegation of power can serve to remove accountability, especially in culturally problematic businesses, is subjected to thorough and proper challenge. It is in the financial sector's best interests to have robust whistleblowing arrangements – trusted by staff and understood by management – to do otherwise in the current economic climate is to take one risk too many. ●

CATHY JAMES, Public Concern at Work >>>>

For more information please visit [www.pcaw.org.uk](http://www.pcaw.org.uk) or call 0203 117 2520.



# Turbulent times for forex? >>>

With the euro finding its future at stake, FX is preparing for a storm of activity, writes **Hilaire Gomer**

**F**X could be about to experience a tsunami of currency activity as the euro finds itself fighting a rear guard action with the dollar and sterling with its future at stake

The FX markets could experience their most testing times to date as closure may loom for the euro. FX surfed the financial crisis robustly, but how well will it cope with the future of Greece and Spain and the currency status quo possibly changing beyond recognition?

As Morten Bech, senior economist at the Bank of International Settlements (BIS), emphasises: "The FX market is one of the most important financial markets in the world. It facilitates trade, investments and risk-sharing across borders."

According to the Bank of England (BoE), the average daily reported UK foreign exchange turnover was \$1.972 trillion (£1.246 trillion) in October 2011, 3 per cent lower than in April 2011, and 17 per cent higher than a year earlier. The decrease in turnover was driven by a 9 per cent fall in FX swaps, while spot turnover rose 2 per cent to a record high. Currency swaps saw a large relative increase (+27 per cent), with turnover rising to a record level.

Bech has estimated that, ahead of the official BIS figures, world FX turnover was about \$4.7 trillion per day in October 2011: "The results [of the research] show that FX activity continued to grow during the first year of the financial crisis but experienced a sharp drop after the

Lehman bankruptcy, from which it recovered only slowly."

Simon Graham, of British FX consultants Validus, concurs with Bech about lower FX volumes – seeing a change since 2007, mirroring the banks' shortage of funds. There is now less available credit for forex deals which has made the market less flexible, less able to cope with extreme fluctuations possibly ahead.

He explains: "In the past if you borrowed £1 million for FX, a bank would never ring you after three months or call your margin, and you could do currency trades as and when. The FTSE companies still do what they want, but for credit-worthy FTSE 250s and smaller firms, FX management is now a big consideration, needing planning. In this market the ideal is to be liquid."

Wholesale currency business carries risk, with every deal there is an instant credit risk. There is also FX exposure when billing overseas. Hedging is essential, for at least you know what your currency position is: you're locked in. In addition, the extreme risk end of the wholesale market involves contracts for difference (CFD), swaps, options, hedging, derivatives and leverage.

A risk is that sometimes FX brokers turn rogue or go bust, as did US broker MF Global in late 2011 while speculating and misusing clients' funds. Happily no outstanding FX credit risk was identified in the bankruptcy.

It is important to make the distinction

between wholesale market where banks carry out FX for businesses, investors, clients and on their own behalf. Wholesale is over the counter, inter-dealer trading, where 'unreal' FX contracts are leveraged, involving derivatives, CFDs, swaps and options. In other words, high risk/reward trading which can lose serious money – and gain as well. At the extreme end, FX is used among others, by spread betting concerns like CNC Markets and GI Markets.

"Forex can be extremely volatile, so a risk manager has to have a programme of hedging strategies he has decided to use and the right set of tools, like futures,"



**“In the past if you borrowed £1 million for FX, a bank would never ring you after three months or call your margin”**



explained an FX consultant.

He continues: "There is freedom of opportunity for lucrative currency crosses and investment, thanks to the ability to trade a variety of currencies around the world - so long as the company understands the pros and cons to trading each currency, and the risks of trading for profit."

Alex MacDonald as CEO of The Wholesale Markets Brokers Association, works with high risk FX – with the dealers who trade between themselves. Even so, he doesn't accept that extreme risk surrounds most FX: "On the whole, a run on a currency is usually due to the citizens of a particular country wanting to repatriate money. Rogue trading in what is essentially a payments system would be dif-

ficult to formulate and almost impossible to hide."

### Regulation

Because of the higher risks involved using CFDs, derivatives and leverage, wholesale FX participants have always been closely regulated on conduct, both by the Financial Services Authority (FSA) and via the Bank of England's Non Investment Products' (NIPs) code of conduct.

In Europe and the UK there is now greater awareness of financial risk, highlighted by the banking crisis of 2008, but reassuringly, the FX markets showed no stress in conduct or positions resulting from the credit crisis.

In Europe and the US conduct regulation is becoming more centralised via the European Securities and Markets Authority (Esma), and the US Commodity Futures Trading Commission which monitors the futures and options markets.

The UK also offers a more

national regulation, but the FSA doesn't regulate FX deals as such, its remit is to oversee the conduct of the traders, according to their client classification and their adherence to the NIPs code. Traders can choose if they wish to be regulated. They don't have to be so long as they don't have access to clients' funds, then it becomes compulsory to be monitored by the FSA.

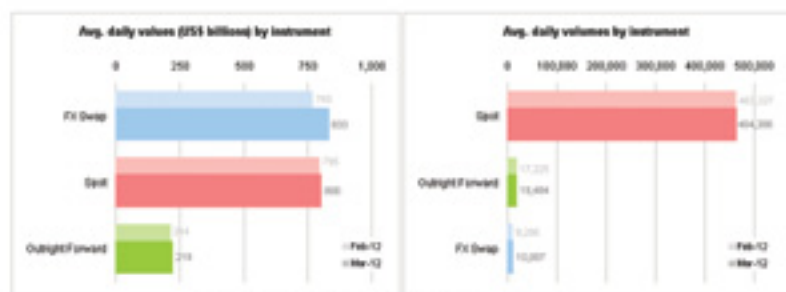
Retail FX needs less regulation because the business of trading currencies is fairly simple. So therefore spot and forward FX are likely to be excluded from the upcoming Markets in Financial Instruments Directive ( MiFID 2) which regulates complex financial instruments like derivatives. Retail FX is a 'delivered commodity' rather than an investment and so don't need the same level of regulation.

So long as a UK forex trading firm doesn't hold clients' money on account it can choose not to be regulated by the FSA. If it chooses to, or has to, it

**\$1.97** bn  
Percentage of FX trade risk  
that is settlement risk



### Value and volume by instrument month on month



The value and volume of trades in the market submitted to CLS by trade date.  
(N.B. The instrument type is derived by CLS and cannot be guaranteed to be 100% accurate.  
90-Swaps are excluded from these figures)







### Foreign Exchange Committee: Survey of North American Foreign Exchange Volume Market Share 1, 2 October 2011

INSTRUMENT	First Quintile (5 Dealers)	Second Quintile (5 Dealers)	Third Quintile (5 Dealers)	Fourth Quintile (5 Dealers)	Last Quintile (5 Dealers)
<b>Spot Transactions</b> percent ranges held market share	>=6.14% 78.89%	4.09 - 1.70% 14.89%	0.96 - 0.72% 4.17%	0.50 - 0.14% 1.64%	<=0.13% 0.44%
<b>Outright Forwards</b> percent ranges held market share	>=7.84% 50.83%	7.58 - 5.85% 32.90%	5.27 - 0.84% 13.16%	0.75 - 0.32% 2.83%	<=0.13% 0.28%
<b>Foreign Exchange Swaps</b> percent ranges held market share	>=6.48% 53.51%	5.75 - 4.10% 23.91%	3.72 - 1.95% 13.47%	1.78 - 1.32% 7.43%	<=1.12% 1.67%
<b>OTC Foreign Exchange Options</b> percent ranges held market share	>=9.85% 64.00%	7.83 - 3.57% 24.76%	3.29 - 0.98% 8.45%	0.90 - 0.22% 2.71%	<=0.10% 0.11%

is compelled to meet strict financial standards like the banks, including show capital adequacy, internal controls and submit financial reports to the FSA. If regulation is not observed by an FX firm the FSA can fine it and/or terminate its regulatory status.

Regulation has a strong impact on currency trading whether in compliance, overseeing dealers, or in monitoring systemic risks. An example of this was last

September when the Swiss National Bank capped its franc at 1.20 per euro because the strength of the currency was injurious to its economy. The cap remains in place, despite the market testing it daily.

One forex trader commented: "Regulation does have an accumulative effect. For instance, only the bigger, closely regulated FX firms had separate client accounts for the FSA. Now thanks to greater FSA control, most traders have

accepted it. This approach squeezes out rogue traders and launderers."

Thus in the UK, if the product is traded by a professional like a dealer, bank or 'eligible counterparty,' the deal is seen to be regulated because these businesses are already extensively regulated by the FSA.

Last November the Bank of England's (BoE) Foreign Exchange Joint Standing Committee, which co-ordinates the FX market practice for stability, liquidity and conduct, added to the NIPs code best practice in electronic trading to include pricing transparency and risk management as obligatory, stating that "all prices on electronic trading venues should be posted with a clear intent to be tradable".

However, everything changed in April because the FSA split in two. This is in preparation for the introduction of three new financial regulatory bodies: The BoE, the Financial Conduct Authority and the Prudential Regulatory Authority. Will this change make FX regulation better?

McDonald comments: "It's a case of making supervision of conduct more effective and the regulation of payments

### Bank of England, UK foreign exchange market turnover by instrument

#### Daily averages in billions of US dollars

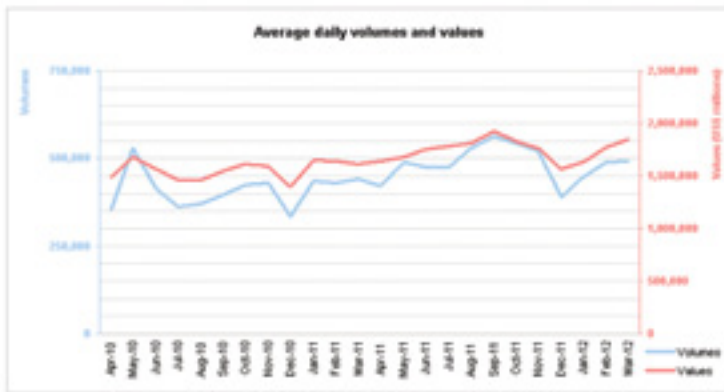
Instrument	April 2011	October 2011
Spot transactions	786	802
Outright forwards	150	156
Non-deliverable forwards	42	38
Foreign exchange swaps	902	820
Currency swaps	21	26
Foreign exchange options	140	130
Total foreign exchange turnover	2,042	1,972

Adjusted for double counting of deals between survey contributors. Totals may not sum due to rounding. Daily averages are calculated assuming 18 working days in April 2011 and 21 working days in October 2011.

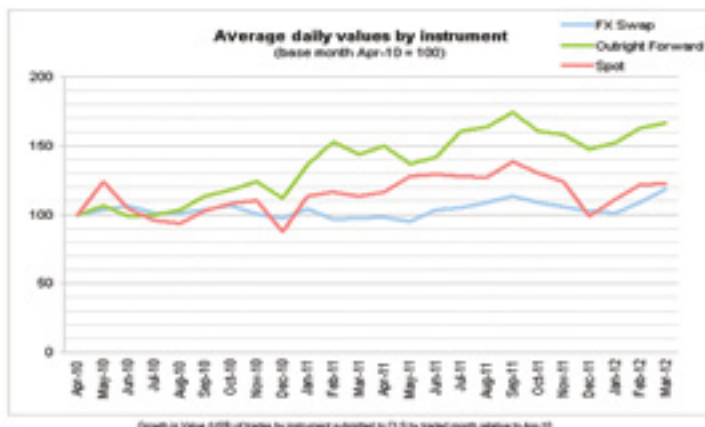
**“It's a case of making supervision of conduct more effective and the regulation of payments more coherent”**

**“In unpredictable times, if a deal feels too good to be true, investigate”**

## CLS Volumes and Values



## CLS index on trade value by instrument



**89%**  
Percentage of FX trade risk  
that is settlement risk

of the trade risk is settlement risk. The FX swaps and forwards market is markedly different from other derivatives markets, and this should be reflected in the regulatory regime to which they are subject.”

Mandatory central clearing of FX swaps and forwards won’t work, argued Citi, nor is it appropriate to apply to FX swaps and forwards the same risk mitigation measures as are applied to other derivative classes because:

- The risk in FX swaps and forwards markets is different and is limited
- These markets are already subject to strong and comprehensive oversight that mitigates that risk
- There would be significant negative consequences for the European economy and for financial stability if those existing mechanisms were disrupted
- International consistency must be maintained

Foreign exchange is always busy and will be busier if Greek and Spanish troubles reach a head.

“We are in quite a risky environment at the moment given what is happening in Greece...so sterling has almost become a safe haven,” says Steve Barrow, of Standard Bank research.

Here’s a final word from an FX trader: “In unpredictable times, if a deal feels too good to be true, investigate.” ●

more coherent inside the dedicated BoE department run by Andrew Haldane.”

The regulation story goes on with big

wholesale player Citi Bank, in a discussion about whether bilateral risk mitigation rules were appropriate.

It said: “In the FX market, 89 per cent

**HILAIRE GOMER**, Financial journalist >>>>

CFTC Commissioner **Bart Chilton** takes stock of where regulation is in the run-up to the G20 meeting next month.

We only need to consider 2008 and the commencement of the crisis — a crappy crisis for which the impacts are still being felt by businesses, economies and consumers. We are still, right now, today, dealing with that calamity and trying to recover. We will discuss the recovery more, but because it can help set the stage for where we are going, let's take a quick trip back to the Financial Crisis Inquiry Commission (FCIC). FCIC was established to examine what took place in 2008 and why. FCIC determined that there were two culprits to the calamity — my phrase, not FCIC's.

- The second culprit to the calamity: The captains of Wall Street. FCIC concluded that since they were allowed to do so much more without those constrictive

Take Credit Default Swaps (CDSs)... please. Just jesting, but these highflying bets upon bets that certain things — say bundles of home mortgages — would actually nose-dive, were new-fangled products fashioned in the wide open



**“With the repeal of Glass-Steagall, regulators got the message to let the free markets roll.”**

## “ If you Google ginormously humongous, it should say ‘see OTC markets’ ”

spaces made possible by the repeal of the Glass-Steagall Act. CDSs were a major part and parcel that helped establish the trajectory for impending economic meltdown. I’m not suggesting all CDSs were or are wicked evil, of course not. I appreciate there are many that had and have a legitimate and valuable function. But just like candy to a baby, too much of a good thing can create major problems, and that is what we saw take place with utterly unregulated CDSs. Countless CDSs took on a circuitous magical mystery tour hyperspace lifecycle of their own. They were traded and re-traded throughout the commercial cosmos. They were packaged and re-packaged, and valued and re-valued around [Wall] Street to the point that few understood what the things were, much less how to place a sound value upon them. In fact, the worth of CDSs was to a large extent in the eye of the beholder. If a firm needed the value to be such and such or this or that, they could make it so upon their balance sheet. Make it so, Number One. And, they did - aye aye, Sir. Just think about Lehman Brothers. In the final statement before they croaked, they held \$691 billion (£428 billion) in assets divided by only \$22 billion in shareholder equity. These guys were leveraged at 30 to 1 for gosh sakes!

By the way, we now have a proposal that would require swap dealers and major swap participants to give their counterparties their valuation of a swap and then to resolve any material discrepancy between their valuation and their counterparty’s before it becomes a big problem.

So, yes, CDSs were a significant component in constructing this

ginormously humongous dark market with no oversight by regulators. When I say ginormously humongous, that’s a technical term. You see, we at the Commodity Futures Trading Commission (CFTC) currently oversee approximately \$5 trillion in annualized trading on regulated exchanges, but the global over-the-counter (OTC) market is roughly \$708 trillion. If you Google ginormously humongous, it should say ‘see OTC markets’.

There’s an old saying in Washington that when Congress feels the heat, it sees the light. And that is exactly what happened in 2010 when Congress passed and President Obama signed into law the Wall Street Reform and Consumer Protection Act — otherwise known as Dodd-Frank.

The most important thing the law brings to markets is transparency. That \$700 trillion-plus over-the-counter market has operated in the dark, without regulatory walls or light — but no more. Thankfully, that is all coming to an end.

Dodd-Frank has over 300 provisions requiring rulemakings — count ‘em — I dare you. We have all seen some of the talking heads on TV say that it’s too much regulation. There are way too many rules. But I think the glass is half-full, that this environment brings about tremendous opportunity for innovation that can once again fuel-inject the economic engine of our democracy.

### The Space Within

The great philosopher Lao Tzu, who is considered the father of Taoism, once said, “The reality of the building does not consist of the roof and walls, but the space

within to be lived.” He also said, “It is not the clay the potter throws that gives the jar its usefulness, but the space within.” This is the same concept we have been discussing. The question arises: What is the correct regulatory structure? It is clear that no or little structure, like we saw in the lead up to the meltdown, wasn’t appropriate. Will all those 300 Dodd-Frank regulations be the right blueprint for our regulatory structure? Did Congress over-reach and go too far the other way? Are regulators going too far?

Yes, in financial markets we need walls and a roof. We need the clay. Let’s think of that as the regulatory environment. In the lead-up to 2008, the clay was pretty soggy — the regulations pretty soft. The roof leaked until the walls, as John Mellencamp croons, came tumblin’ and crumblin’ down. We had a financial disaster because nobody could see — least of all us regulators — what was going on in that space within. To some extent, Wall Street in the OTC space was more like a credit casino than anything else.

Well, the walls came tumblin’ and crumblin’ down for not only Lehman Brothers, but months before we saw Bear Stearns tank. I don’t have too much sympathy for those folks, but I have a lot for the American taxpayer who was saddled with a repugnant relief effort known as the Troubled Asset Relief Program, or TARP for short. In total, \$414 billion was allocated. Of that, \$74 billion remains outstanding. As the FCIC said, the captains of Wall Street had their own playground and the regulators walked by without ever seeing anything amiss.





I contend that Dodd-Frank struck the right balance on the regulatory structure. It remains to be seen if regulators themselves will build appropriate internal walls and leave enough space within the walls. I believe we will. What has been done so far, by and large, has been pretty respectable and very substantial. At the CFTC, we have completed 31 of the roughly 50-plus rules, and we have not done them on a clock. We have not hurried them, but taken tens of thousands of comments and worked to get them correct. What has been done so far leaves a lot of room for genuine innovation and real creativity, real competition and real opportunities for economic progress.

There is even more room for innovation in the things that we will do in the next few months. Here are just

a few: 1. Dodd-Frank told us to ensure that all products that could be cleared were cleared. There is a lot of room in the clearing arena for innovation and competition, for new or expanding businesses. 2. The law also instructed us to ensure that products are, to the greatest extent possible, traded either on an exchange or on what are called Swaps Execution Facilities or SEFs. I'm not sure how many SEFs will exist, but there will be a handful for sure and perhaps many. They will provide transparency and make for safer markets. They will compete. They will be individual economic engines for our financial markets and our economy. 3. There will be warehouses for all of the swaps data in the form of Swaps Data Repositories or SDRs. Here again, these are new businesses that will help provide

transparency and safeguard markets while generating economic value for markets and economies; and 4. Think about the technological innovation — both software and hardware and the people in the private and public sectors who work on both — that will go along with all of these new systems and products and businesses. There is a mansion-load of space between the walls and a genuine opportunity for a great global financial future.

#### **Roaming Regulatory Regimes**

In 2009, in Pittsburgh, the G20 met and agreed that they would all work to clear any trade that could be traded and to move as many trades as possible to either exchanges or other trading platforms and that the reforms should be completed by the end of this year. I'm not sure all of



“I’m not sure how many SEFs will exist, but there will be a handful for sure and perhaps many”

## “ In this age of global financial markets, effective reforms cannot be accomplished by one nation alone ”

the G-20 nations can make that deadline, but we have seen sure-footed progress in the US, Japan and in the European Union (EU). The G20 meets again in Los Cabos in June, and we will see if they alter the goal timetables, but either way, nations need to do their honest best to comply with the agreement. Of course, some nations won't move as quickly as others.

In this age of global financial markets, effective reforms cannot be accomplished by one nation alone. They will require a comprehensive, international response. If we don't do this together or at least in the same vein, we run the risk of regulatory arbitrage. I'm not suggesting that the EU or Canada or Japan or Singapore or Brazil or Hong Kong have to do precisely what the US does. We all have sovereign issues, and we have diverse markets, let alone different interests that we all need to consider.

However, we also have a lot in common. We all want to guard against systemic risks that can result in an impact on our national, regional or our world economy. As we know, we are all linked in today's world and one economy has an impact upon another. So, to the extent that we can approximate harmonisation, we will be better off individually and collectively. We shouldn't open the door for regulatory arbitrage or trading migration to nations with the thinnest of rulebooks. Solid, but appropriate, regulation globally will lead to greater confidence and greater opportunities for consumers, businesses, markets, and economies. Practical, reforms need to be developed and implemented in an

interdependent and interactive fashion. I'm convinced that global financial regulatory reforms will take place eventually. It is certainly my hope that this takes place sooner rather than later.

### A Wilde Ride

It has been a pretty wild ride since 2008. But I'm very optimistic about the progress that has been made. I see great opportunities in our financial markets, from having more financially literate consumers to having a more transparent and competitive marketplace full of new and never-before-built businesses.

Oscar Wilde — remember him, the long-haired cultural commentator from the late 1800s? I love one of his quotes. He said: “To expect the unexpected shows a thoroughly modern intellect.”

We are in the midst of a mind-blowing phase, right now, in the financial world. The space within the walls is going to be bursting with new players, new exchanges and things we hadn't even contemplated. It reminds me of the Wilde ride of the 1880s in that way.

### The Economy

Plus, the economy is on the right track. That's exciting, too. In the US unemployment is consistently ticking downward. We have seen consistent job growth with 4.1 million jobs created in the past 25 months. Consumer spending is up, and we have seen the biggest gain in home building in two years. Cars sold at their fastest clip in four years. Last Friday, we learned that the Gross Domestic

Product (GDP) is trending very positive. We have seen 11 consecutive months of economic growth.

Think about where we were. In the final quarter of 2008 when those walls were tumblin' crumblin' down, the GDP was NEGATIVE 8.9 per cent. What a gargantuan train wreck! That was the second worst quarter ever recorded. The worst quarter, by the way, was back in 1958 when GDP reached a negative 10.4 per cent. Quarterly GDPs were not tracked during the Depression, but the worst overall year for GDP was 1932 at a negative 13.1 per cent. The average GDP since 1946 has been 3.2 per cent, so negative 8.9 per cent in Q4 of '08 was extensively horrific. While the GDP for Q1 of this year slowed to 2.2 per cent (it was 3.0 per cent at the end of 2011), most economists still see this as a sustainable recovery. Gone is the talk about a double-dip recession. There is still positive and consecutive economic growth.

### Conclusion

So, I'm very optimistic about the economy, about what we can do on financial literacy and what can be done on the regulatory front if we allow for the proper space between walls and we believe, like Oscar Wilde, and expect the unexpected. ●

This is an edited version of a speech given to the Finance, Credit and International Business Association on 3 May 2012 in Illinois, US.

**BART CHILTON**, Commissioner, Commodities and Futures Trading Commission >>>>>>>>>>



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# Outnumbered but unbowed?

Germany is Europe's powerhouse. But with the euro-crisis continuing, the country is finding itself outnumbered in its austerity drive

**G**ermany is the largest national economy in Europe, the fourth-largest by nominal GDP in the world, and fifth by GDP (PPP) in 2008. Germany is the world's second largest exporter with \$1.474trn (£0.946trn), €1.06trn exported in 2011. Exports account for more than one-third of national output.

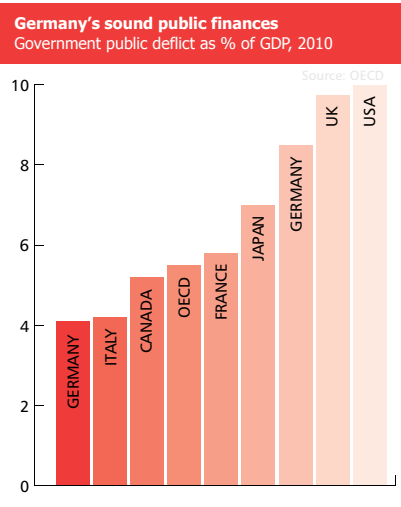
The service sector contributes around 70% of the total GDP, industry 29.1%, and agriculture 0.9%. Most of the country's products are in engineering, especially in automobiles, machinery, metals, and chemical goods.

## The economy

Germany's economy has grown by 3% or more in each of the last two years and even with the eurozone crisis, saw a Q1 growth of 0.5% after contracting in the last three months of 2011.

Germany's unemployment rate continues to fall, dropping below 7% in May at 6.7% with the number of people registered as unemployed down 108,000 to 2.86m — the lowest level since December.

Despite the good figures, there are signs that the resilience of the German labour markets is weakening and the effects of the eurozone are seeping into the system with business confidence dropping after several months on the rise. In addition, it faces a cyclical return to slower growth rates and challenges to the foundation for long-term growth.



According to the OECD, there are numerous downside risks posed by the global slowdown, the deterioration of world trade and the euro area debt crisis. Given the weight and importance of Germany's economy for Europe, growth-enhancing structural reforms can make an important contribution to stronger and more balanced growth perspectives not only in Germany but also in the Euro area.

The OECD added that: "In a long-term perspective, Germany needs to transform its growth model to thrive as a knowledge-based economy. This transition requires policy efforts, investment and reforms in education, skills and innovation and continued leadership in green growth. But it also needs to work towards less burdensome regulations of services, increased labour

participation of women and older workers and, thus, strengthening domestic demand.

"Germany should also compare itself with other economies in the emerging world, and be ready to compete with countries that have been growing at higher rates for quite some time now."

## The eurozone

The euro falling by 6.4% in May was good for German exports, but political backlash of a Greek exit, or Spain becoming the next in line for a fall, is growing with the political consequences of Germany's push for austerity is reaching the fore.

The country appears to be isolated with the Latin bloc of countries, including France, in looking to loosen the austerity programmes and direct financing for banks.

Germany is spearheading resistance to direct European financing for banks because that would let governments bypass the conditions set for full aid programs, such as deeper budget cuts and more European intrusion into economic management.

With other countries looking for a solution that goes against Germany's long-term and constitutional economic discipline, the answer may be one that is unexpected and instead of a Grexit, the solution could be a German *ausfahrt*. ●

SOURCE: CIA FACTBOOK, OECD, EUROPEAN COMMISSION, BUNDESBANK, GOLDMAN SACHS, INTERNATIONAL MONETARY FUND, OECD



# Capitalising on risk >>>>>>>>



**Name:** Clare Wood >>>>>>>>>>>>>>>>

**Position:** Head of Portfolio Risk Management

**Date joined the company:** 2 November 2009

**Interests and hobbies:** Music, French and Reading

## 1) How did you get into the risk profession?

I started off as a quantitative analyst at an equity long-short hedge fund, designing and testing trading strategies. I became a portfolio manager running a collection of strategies invested in US equities. The fund was hit by the quant fund meltdown of the summer of 2007 and after that the principals decided to wind up the business. The experience of investing showed me that I would prefer to analyse portfolios than manage them. I took a job at a fund of hedge funds, analysing the risk of hedge funds with a range of different strategies from distressed credit to global macro to equity hedge. There I learned about other asset classes and strategies and took the FRM exam. From there I came to Kames to develop the newly created Portfolio Risk Management team.

**2) Did you always intend to go into risk?**

No, I started in front office and moved into risk when I decided that I didn't want to be a portfolio manager. I enjoy analysing the risk factors and contributions in a range of different portfolios, across equity, fixed income and multi-asset and from retail funds to liability driven portfolios.

### 3) What are the key issues for a head of risk at the moment?

One of the major issues at the moment

is the pace of regulatory change. Changes are coming from multiple directions, not just the

FSA but also European directives and the SEC in some cases. And there is also Solvency II, which is a regulatory change for insurance companies but also impacts any asset manager that invests money for an insurance company. Another issue is counterparty risk management, a risk that was not high on everyone's priority list five years ago. There has been a sea change away from the view that cash is the lowest risk asset and a more active consideration of cash management, and related activities such as collateral management and securities lending.

#### 4) How do you approach these issues?

Within Kames we have a multi-disciplinary approach to addressing issues, with a key group of individuals from across front office, operations, portfolio risk and regulatory and operational risk that work together to decide how best to address each of them. This could be through changes to existing processes or setting up new processes and initiatives. This group works within the governance framework of Kames Capital and reports up through it to ensure that senior management are aware of everything that is happening and that sign-off is given at the correct level.

### 5) How do you keep up with events both macro- and micro, domestic and international?

I keep up with events using both

external and internal sources. External includes: reading the financial press, checking market movements and news on Bloomberg, being involved in risk management forums and with the Investment Managers Association. Internal includes: attending monthly investment policy meetings, reading internal market commentary and by talking with fund managers.

## 6) How has your industry changed?

There is much more focus on portfolio risk than there used to be. Historically, it was the banks and insurance companies, who kept the market and credit risk on their own balance sheets, that were most focused on measuring the risks in their portfolios. But increasingly, both due to regulatory changes and increasing investor sophistication, there is a need to provide robust and meaningful market and credit risk measurement and management within the asset management industry.

## 7) Where do you see the key areas going forwards?

The key area for asset management going forward will be addressing changes in investors' requirements, particularly in the "At Retirement" market. This will require different types of products and investment strategies and a move away from relative risk and performance measurement to absolute. We will increasingly see more absolute return, total return and asset allocation products enter the market place, with an increased focus on risk management. ●



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