Risk Management

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Protection becomes a scarcer resource

'Watch this space' is the latter day mantra of an industry reeling from scandals and the costly fallout that has followed, reports *Alistair Gray*

It has seemed like one thing after another. From interest rate rigging to alleged money laundering, several of the world's biggest financial institutions have been caught up in an ever-growing list of scandals.

The misdeeds – and accompanying fines, litigation and reputational damage – have raised important questions about the institutions' business practices, several of which are examined in the following pages.

A less frequently asked – yet instructive – question is what those misdeeds mean for insurance companies that provide coverage to the industry.

"We've seen carriers [insurance providers] starting to tail back their capacity for large financial institutions," says Ramesh Singh, a financial institutions expert at the insurer AIG.

Insurance is an important means by which banks can manage operational risks. It is vital that they can buy protection at sensible prices.

"Bankers want to bank," says Richard Magrann-Wells, a New York-based financial services practice leader at Willis – a go-between for underwriters and companies that want to buy insurance. "They want to focus on lending risk and trading risk."

He adds: "The risks that they don't want, they're happy to allocate to insurance."

To be sure, in some areas of insurance the recent misdemeanours at big institutions had little or no impact.

In insurance lines such as property, underwriters have tended to treat the financial services sector as they would most others: the headquarters of a bank is just as likely to be flooded as that of a retailer.

For other important types of coverage, financial services businesses pose fundamentally different risks from those of other companies. This is because of the complexity, size and nature of the institutions' business, as well as the extent of regulatory scrutiny. In the wake of the recent scandals, two types of policy – both especially important for banks with operations or listings in the litigation hotspot of the US – are in focus.

The first is professional indemnity (PI) insurance, known in the US as errors and omissions protection. This covers companies against claims – from shareholders or clients – that they have suffered losses because of alleged mistakes or negligence.

The second is directors and officers (D&O) insurance. This covers the costs to senior managers and board members of becoming embroiled in legal action or regulatory probes.

Given the personal risks to which individuals in such positions are exposed in the course of their jobs, leading officials at big banks generally insist their employers take out, on their behalf, policies to cover them.

But insurers have been nervous about providing these types of coverage to big banks for years.

This is, in large part, because of past scandals such as so-called IPO Laddering, when investment banking advisers were accused of artificially stimulating demand for newly issued shares of technology companies during the dotcom boom. Brokers and lawyers warn that insurers have become even more concerned about the financial services sector since the 2008 crisis. Underwriters need not look far for reasons to be nervous.

"Insurers have been looking at the landscape fairly pessimistically," says Charles Beresford-Davies, head of the UK risk management practice at the insurance broker Marsh. "Every time everyone thinks it's done, something else comes out [of] the woodwork."

In recent months, Barclays, UBS and Royal Bank of Scotland have been hit with fines over Libor rate fixing that, together, run into billions of dollars. In the UK, lenders have set aside about £14bn to cover compensation for mis-selling payment protection insurance.

Many of the most obvious associated costs are uninsurable. Notably, to minimise moral hazard – the risk that insurance can encourage recklessness – regulators in big markets such as the US do not allow companies to buy insurance against fines.

However, underwriters are on the hook for other expenses such as legal costs. "It's not the bomb blast that insurers are afraid of," as Mr Magrann-Wells puts it. "It's the fall out – the litigation that may follow."

This is underscored by the insurance claims resulting from the collapse of smaller US banks during the height of the crisis that are only now beginning to be made.

The Federal Deposit Insurance Corporation is pursuing legal claims against former executives as it seeks to recover at least some of the billions of dollars in payouts it had to make.

Of all the types of expenses incurred by financial institutions that could make for insurance claims, those arising from securities litigation are the most frequent, suggests data compiled by Advisen. Its database tracks more than 19,000 instances of losses incurred by financial businesses, accounting for more than $730bn in total. Securities-related costs accounted for almost 7,000 cases, with total costs of almost $100bn.

> 'Insurers have been looking at the landscape fairly pessimistically'

The most obvious way in which underwriters express caution about providing important classes of insurance to big banks is through higher premium levels.

Aon, the insurance broker, says D&O pricing for financial institutions is "collectively higher than almost all other industry groups".

Underwriters caution about generalising but privately say it would not be unusual for banks to pay premiums four times higher than those of other similarly sized companies for PI and D&O insurance.

They estimate that, in recent years, rates for such lines of insurance have risen by about 10 or 15 per cent.

The global insurance industry remains well capitalised, however, a phenomenon that is keeping the market competitive and putting a lid on rate increases, in spite of underwriters' concerns. "Insurers have been calling for higher rates for some time but, because of overcapacity, we haven't seen that follow through [to higher prices across the board]," says Mr Beresford-Davies.

Insurers can respond by reducing their levels of exposure: lifting deductibles, the amount policyholders need to stump up before insurers pay out, and lowering upper limits.

Even after insurers club together to cover a particular institution, individual banks struggle to secure professional indemnity and D&O coverage beyond £500m, say brokers.

"The amount of capacity available for these banks has dropped over [several] years fairly consistently," says David Rogers, London-based financial institutions broking director at Willis.

To further limit their exposures, insurers have been tightening how they word policies. When policies at institutions hit by particular problems come up for renewal, brokers say, underwriters insert exclusions that leave the institutions unprotected from future regulatory or legal action.

For this reason, several lawyers believe big banks will be unable to make many successful insurance claims over costs arising from the scandals such as Libor.

Even so, underwriters that provide PI and D&O coverage to big banks will be watching class action suits and legal demands closely in coming months. Analysts have estimated banks' total potential exposure to lawsuits relating to the Libor scandal to be as high as $35bn.

"Libor is a watch-this-space," says Mr Singh. "It will take several years to understand the full repercussions."

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Benchmarks

A wider range of participants is key to a credible process, says *Brooke Masters*

Until recently, few investors, bankers or regulators gave more than a passing thought to the benchmarks and indices on which the financial world runs. To be sure, there have been complaints about the influence of "speculators" on energy and other commodity benchmarks, and the quarterly reconstitution of the many equity market indices has always been a headache for tracker funds. But, no one, least of all compliance departments, spent much time worrying about the fundamental fairness of various rates.

The growing Libor rate-fixing scandal has changed all that. Three global banks have already paid more than $2.6bn in fines for fixing or trying to fix interbank lending rates set in Brussels, Tokyo and London, and there is growing evidence that rates set in Singapore, Australia, Switzerland and elsewhere were also subject to pressure from traders seeking to make money on derivatives.

Market confidence has been undermined, and bank internal watchdogs have been caught flat footed. Barclays and UBS have admitted that their compliance and internal audit divisions failed to spot persistent rate manipulation efforts, despite multiple reviews. Royal Bank of Scotland has acknowledged that it did not even realise there was a potential problem with having the same people help set the rates that they then traded on.

International regulators, led by the US's Gary Gensler and the UK's Martin Wheatley, are also looking at whether other benchmarks, in energy, precious metals and other kinds of financial derivatives, are similarly vulnerable and need to be rethought.

"The restoration of confidence in indices and benchmarks is crucial to the stability of the global financial markets and wider economy," says Andrew Knowles of RIMES Technologies, which provides bespoke data services, including benchmarks, to buy-side firms. "A regulatory knee-jerk reaction to the Libor scandal is not the answer. The issues need a considered review of the high level principles under which each index type is operated, and enforcement of sanctions where necessary, to prevent irresponsible actions by market participants."

Cleaning up the benchmark world will not be an easy task. Some indices, particularly those based exclusively on transactions from busy markets, are probably already clean and reliable. Many others, including the London Interbank Offered Rate at the heart of the scandal, have historically had to include an element of discretion simply because there are not enough transactions. In Libor's case, that meant relying on a relatively small number of banks to estimate the rates at which they could borrow and then tossing out the top and bottom bids and averaging the rest.

While, on the surface, the rate-setting process looked tamper-proof, it turned out to be vulnerable to a few determined traders, who worked with interdealer brokers to move the Libor rate a few basis points one way or the other to make money on particular interest-rate derivatives.

The problem was partially inattention. The sponsors of equity indices make money by licensing their products and fiercely guard their reputation for accuracy as a result.

The rate-setting banks, by contrast, had no such motivation, and the process was often left to relatively junior treasury employees or interest rate traders themselves.

"Libor is an index that arose out of banks' other activities, namely making loans. It is thus a by-product of that activity. Banks do not have any significant revenue stream that arises from the index itself, so they don't have much to lose if their actions discredit the index," says David Ellis of FTI Consulting.

In the future, regulators and market participants will need to make sure that the rate-setters are more focused on the accuracy of their benchmarks. Formal regulation of the process is coming, at least in the UK, and that will help. So will rules insisting that estimated rates be based on transactions or on some other objective evidence wherever possible.

"A reliable benchmark is one that is based on transaction evidence, is automated and is supported by an independent governance process which guarantees the accuracy and the neutrality of the output," says Kevin Milne, chief executive of Rate Validation Services, a benchmark provider. "In the absence of trade data, the only fallback option is 'expert judgement' [but] the standardisation of the methodology through which an expert arrives at their informed opinion will assist by reducing the risk of bias."

Perhaps the most important improvement would be to expand the number and kinds of participants in the rate-setting process. Cabals are less likely to form when rate-setters include institutions with fundamentally different interests.

"We must learn to rely on a smaller number of rates which are based on submissions from a wider range of market participants in order to protect against the sort of manipulation which we have seen, and ensure that the rates are credible," says Kevin Burrowes, leader of PwC's UK financial service team.

International oversight: Gary Gensler, chairman of the US Commodity Futures Trading Commission Bloomberg

A ratings game that helps deliver a brighter future

Spain

A closed market forced a much-needed rethink, says *Miles Johnson*

For years Spanish executives greeted the idea that their country could slip out of the eurozone with incredulity. Yet, last summer, as Spain's government borrowing costs shot to the highest level since it left the peseta, what was once an improbable nightmare was creeping ever closer to reality.

In July, before Mario Draghi, president of the European Central Bank, pledged to do "whatever it takes" to keep the single currency intact, Spanish businesses were living through the most intense days of Europe's financial crisis. Specially assembled teams within some of Spain's largest banks and non-financial companies were assembling contingency plans in case investors suddenly refused to lend them any more money.

Even Banco Santander, the largest lender in the eurozone by value with operations across Europe and Latin America, and BBVA, also internationally diversified and Spain's second biggest bank, found themselves locked out of financing markets at that moment, with international investors shunning any borrower associated with Spain.

"The markets were closed for a long time, and are still somewhat closed to some players," says Pablo Campos, managing director of Oliver Wyman in Spain.

Other companies, fearful that a Spanish sovereign credit rating downgrade would see their own debt downgraded, and make borrowing even more difficult, began to take steps that would have been unimaginable just a year before.

Telefónica, the former Spanish state telecoms monopoly, began to spin off its prized Latin American division, as well as selling a stake in its German operations, as credit ratings agencies warned that it too faced a downgrade.

"In those weeks no one knew what was going to happen," says a senior executive at one of Spain's largest companies. "Many were fearing a disaster

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Safety net plans raise industry ire

Some money market fund managers are fighting tooth and nail against many of the proposed reforms, writes *Brooke Masters*

Shadow play: London's Canary Wharf financial district Reuters

Now that global regulators are nearly done with the Basel III reform package aimed at making banks safer, their attention has turned to other parts of the financial sector that could either help banks evade the rules or pose similar risks.

This focus on so-called "shadow banking" is driving a series of new proposals aimed at preventing systemic risk from building up in hedge funds, private equity groups and other relatively lightly regulated bodies. Led by the global Financial Stability Board, regulators and firms are looking particularly closely at activities that mimic banks, either by extending credit or by providing maturity transformation – using relatively short-term funding to provide longer-term loans.

The early work has focused on entities such as money market funds, which provide investors instant, or nearly instant, access to their money, as well as practices such as securities lending and margin loans, where credit is being extended without the same sort of oversight that occurs when a deposit-taking institution offers loans

Regulators are reacting to key events during the 2008 financial crisis – banks were forced to absorb losses when special investment vehicles they had set up proved to have inadequate capital; a US money market fund sent shivers through the broader market when it "broke the buck" and stopped guaranteeing a fixed net asset value of $1 per share; and Lehman Brothers found itself hopelessly overleveraged and unable to draw on the US Federal Reserve's discount window because it was not a deposit-taking institution.

"If it looks like a bank and quacks like a bank, it has got to be subject to bank-like safeguards," Lord Adair Turner, the UK regulator who has helped lead the FSB work, has said.

Progress is being made. US officials are making their second attempt to push through changes to the rules for money market funds, and bank regulators Paul Tucker of the UK and Daniel Tarullo of the US have talked about setting minimum margin requirements. While the industry calls this price-fixing, some regulators think haircuts keep credit from getting too cheap and, along the way, can prevent another asset bubble.

Before a new bubble can get underway, policymakers face a dilemma of a different sort. Banks have been pulling back from lending, thus shrinking their balance sheets as they seek to build up their capital ratios. If the world economy is to grow, other sources of finance are needed, and shadow banking – known as market-based finance, in its more benign guise – is starting to fill the gap.

"Institutional investors are increasingly allocating funds to direct lending, either indirectly via private equity owned credit funds with long lock-up periods or directly via newly set up in-house direct lending operations," says Jason Green, a debt and capital advisory partner at PwC.

> 'If it looks like a bank and quacks like a bank, it has got to be subject to bank-like safeguards'

The growing importance of shadow banking creates its own policy issues – officials must now figure out how non-bank sources of credit will be monitored and channelled without choking them off entirely.

Consider, for example, the experience of the City of London Group, which has added merchant banking functions to its traditional investment management business

"The lending we are generally involved with can range from 60 days to five years and the loans are structured and tailored to meet the clients' business and cash flows. Investors are given the duration that their funds are committed for and also the expected risk reward ratios," says Eric Anstee, chief executive.

"To suggest that this requires additional regulation or controls would be to limit the market and, potentially, choke off a new form of funding to the real economy."

Some industry analysts say concerns about liquidity runs in shadow banking are overstated.

"It is hardly in the interests of investment managers to allow for their funds, securitisations and SPVs to have liquidity mismatches," says Christian Parker, partner at lawyers Paul Hastings.

"Investors at whom these products [are aimed] are sophisticated enough to understand the asset classes and related liquidity and will likely look askance at, for example, an open ended loan fund that gives instant access to their money. And, if an investment manager mismanages their funds' liquidity, they tend to struggle to raise new money."

Stuart Opp, investment partner at Deloitte, agrees. "After the market disruption of 2008, fund developers factored liquidity into the design of their products much more effectively. The result is that most of the capital being redeployed by these shadow lenders is with unleveraged or lightly leveraged sophisticated investors' risk capital, in fund structures very similar to private equity funds," he says. "As a result a run on a bank is unlikely in a traditional sense."

Money market fund managers are fighting tooth and nail against some of the proposals, such as higher capital requirements, and measures to force them to use a floating, rather than fixed $1 value for their shares. They say regulators are undermining their business models in the name of providing safety levels that investors do not need and are not asking for.

"The regulators are generally fighting the last war." says Neil Hamilton, another Paul Hastings partner.

Ratings game for brighter future

Continued from Page 1

unless Europe stepped in."

Since those bruising days, Mr Draghi's intervention seems to have significantly reduced the risk of Spain needing a bailout. In the eyes of investors, Spanish companies have learnt several lessons.

First, in a country where some of the largest listed companies had still, up to the start of the crisis, relied almost entirely on bank lending, the importance of developing an investor base within the bond capital markets has become clear.

Previously, many large companies had treated the idea of obtaining a credit rating, and thus permitting intrusive access to ratings agencies, as an unnecessary inconvenience.

But Spanish executives have learnt that, during a banking and real estate crisis, domestic bank credit dries up as lenders rush to reinforce their own balance sheets.

Without any precedent of accessing the international capital markets, companies have been left at the mercy of banks' risk committees under orders to reduce their exposure to corporate Spain.

Now, most companies in the construction sector, which had shunned the use of bond market financing, have obtained or requested credit ratings. Ferrovial, the building and infrastructure group that controls London's Heathrow airport, last January sold €500m of five-year bonds to a pool of largely international investors.

Yet, for the banks, which had used billions of euros of cheap loans from the ECB to load up on Spanish sovereign debt, thus tying their fate even more tightly to the health of the government's finances, the situation was more complicated.

"We saw the concern of our clients about the new scenario," says Mari Carmen Laguarda, managing director of risk consultants Marsh in Spain and a specialist in financial institutions. "They were well aware that if it was not handled properly [it] could mean the disappearance of work and effort of many years."

Advisors to Spain's banks, which have undergone a whirlwind of transformation through mergers and nationalisation since the crisis began, say the key was to be as internationally diversified as possible.

With investors fearful about not only the future of Spain's place in the eurozone, but also the ability to remain profitable in a highly congested market suffering a sharp recession, the need to show earnings in faster growing markets became ever more apparent.

But, aside from Banco Santander and BBVA, Spain's other leading lenders have next to no exposure outside their home market. While Santander was able to raise money by selling assets in Latin America, others were forced to take uncomfortable steps closer to home to rebuild their balance sheets.

AFP

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Banks debate liquidity trade-off

Liquidity

Tracy Alloway looks at financials' options to build up their war chests

When Basel banking supervisors unveiled loosened liquidity requirements in January, one could practically hear the cheers emanating from financial centres around the world. Not only did the regulators widen the types of assets that could be included in banks' so-called liquidity buffers, they also extended the deadline for compliance.

The watered-down liquidity requirements meant that US banks' collective liquidity coverage ratio shot up from 81 per cent to 94 per cent in a single day, according to estimates from The Clearing House, an industry group, and Citigroup analysts. That is just 6 percentage points shy of the 100 per cent they will ultimately need to achieve.

"There was a feeling with some of our clients that this is off the agenda now," says David Little, director at Calypso Technology, which provides liquidity-related software for banks.

"There's a sense that regulators are beginning to blink, if you like, in the high stakes pressure game of financial regulation. If they backed down on LCR, then maybe they'll back down on other things too."

Under the proposed rules, banks have to hold a buffer of high-quality and liquid assets to cover their estimate of the amount of funding they might lose over a 30-day period.

The ratio between those liquid assets and estimated outflows is the liquidity coverage ratio, or LCR. It is a key plank in regulators' attempts to prevent the kind of market turmoil witnessed during the depths of the financial crisis.

While holding large war chests of ostensibly liquid assets makes sense from a financing perspective, there is an economic trade-off. Liquid assets tend to be less profitable for banks and maintaining the buffer effectively ties up more of their balance sheets, supposedly restricting financial institutions' ability to lend.

Regulators say they had this trade-off in mind when they opted to soften their original LCR proposals.

Banks will now be able to include a host of assets, from residential mortgage-backed securities (RMBS) to different types of corporate bonds, when building their buffers. They also have until 2019 to comply fully with the new rules.

"Since we attach great importance to try to make sure that banks can indeed finance a recovery, it does not make sense to impose a requirement that might damage the recovery," says Mervyn King, former Bank of England governor.

That trade-off between economic interests and higher liquidity is one that banks' risk managers, treasurers and executives will also now have to confront.

"The extension of the compliance period for LCR poses a difficult problem to banks which are already compliant with the existing LCR requirements," notes Alexander Batchvarov, strategist at Bank of America Merrill Lynch.

That is because banks have to choose between holding big buffers of liquid, but low-yielding assets for the next six years, or selling the assets now and then rebuilding their buffer before the 2019 deadline.

Risk experts say whether banks opt to go over and above the LCR rules will depend on a multitude of factors, including their perceived risk profile, jurisdiction and type of business.

> 'What the lenders want to do is move as many "unstable" deposits to the "stable" category'

Banks that are aiming to attract retail depositors, for instance, may find that holding a big buffer of liquidity could be a selling point to customers.

"It really depends on which jurisdiction you're thinking about. I think that in Canada, for example, they will definitely go above it," says Mayra Rodriguez Valladares, a former Federal Reserve Bank of New York analyst, who runs her own consulting business.

Others say the decision may depend on the final outcome of the rules. Basel has yet to set out the penalties for not complying with the liquidity rules, for instance. "My guess would be that if the consequences are quite severe then the banks will have a bigger buffer," says Joo-Yung Lee, head of the North American financial institutions group at Fitch Ratings. "If the consequences are light they may move towards the minimum."

Few wish to be on the low end of the LCR once markets go awry. That might mean many banks end up clamouring for more liquid assets just when markets are beginning to turn.

"You really don't want to have a number 100 when the stuff is hitting the fan," says one risk manager at a top European bank, referring to the 100 per cent liquidity ratio banks will be required to hold. So maybe you want to get to 120 before this happens."

Meanwhile, the savviest banks are working on ways to engineer more cheaply their liquidity buffers.

Much of the work involves shuffling portfolios of assets to find the best trade-off between profits and regulatory capital. For instance, a liquidity buffer built of sovereign bonds, corporate debt and RMBS will probably generate a higher net yield for a bank than a portfolio comprised of just highly-rated government debt and covered bonds.

"What the banks want to do is move as many 'unstable' deposits to the 'stable' category," says Mr Little. "They're constantly dreaming up new ways to analyse the data to present to the regulators."

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Designs on ethical products point way forward

UK mis-selling

Simplicity and transparency are the new watchwords, reports *Jennifer Thompson*

Poor deal: banks have paid dearly for payment protection insurance Alamy

The sum is eye-watering.

Since 2010 Britain's biggest banks – Barclays, Lloyds, Royal Bank of Scotland, Santander and HSBC – have collectively set aside about £14bn to cover the cost of mis-sold payment protection insurance, making it the costliest consumer scandal in the UK.

The product, designed to cover borrowers' loan repayments if they became ill or lost their job, has become a byword for egregious malpractice in retail banking: a focus on making profits at whatever cost to the customer.

The bill was ratcheted up last year when lenders also began to set aside funds to compensate for interest rate hedging products potentially mis-sold to SMEs, after a pilot study by the Financial Services Authority suggested that many of these sales could have fallen short of regulatory requirements.

"It's a wakeup the industry has been through: that the only reason we exist is because customers choose to do business with us," says Stuart Haire, chief risk officer for UK retail at RBS.

But, although the cost of unravelling past mistakes continues to weigh on banks' reputations, as well as their accounts, behind the scenes the landscape has fundamentally changed.

Both the process of designing and selling products have undergone radical overhauls. This trend began in the mid-2000s, but was ramped up once the scale of the PPI scandal, in particular, became apparent.

The more considered approach has sought to reconcile the fact that, while reform is necessary, there remains a real need for certain complex products, however tarnished the terms "PPI" and "derivatives" have become in the minds of consumers.

The prevailing philosophy within institutions now is to consider the entire lifetime of a product, with risk management concerns being considered at a much earlier stage in the process. This is most visible with an emphasis, across the board, in ensuring sales practices are ethical.

But, fundamentally, banks believe it starts with more considered product design. "If you've got the wrong product in the wrong part of the chain in the first place it will get to the wrong people," says Fiona Fry, partner and head of regulatory risk consulting at KPMG.

Consultants and risk officers agree that the biggest area of change in recent years has been the growing emphasis on whether products will meet customers' needs.

"In the past [risk officers] spent a higher proportion of their time looking at more prudential risks," says Mr Haire. "But now there is a greater focus on conduct risks, focusing on customer outcomes."

The watchwords are simplicity and transparency, which have seen greater importance placed on feedback from customer surveys, complaints data and focus groups.

Another focus has been beefing up the contribution of risk and compliance departments in the process.

"The involvement of the risk and compliance departments now comes much earlier in the process," says Ms Fry. The stress-testing of products, previously often regarded as a 'signing off' duty, is now viewed as a valuable part of development.

The impetus for improving design and sales technique to some extent predates the PPI scandal, the cultural shift having begun in the mid-2000s to reflect the FSA's principle of treating customers fairly.

> 'Now there is a greater focus on conduct risks'
>
> Stuart Haire, RBS

But the shift was spurred by the magnitude of that affair.

All major banks have altered the models used to incentivise staff in branches, shifting in various degrees from an emphasis on sales targets to customer service ratings to ensure that goods reach the right people.

The next steps for improvement, industry advisers say, will be in simplifying product ranges and improving the tracking of products once they are sold to customers.

"The challenge is to simplify the on sale product range, that's creating the back book of the future," says Ian Walsh, partner at Boston Consulting Group, adding that many banks still need to manage products no longer offered for sale, but which date back decades and still need servicing.

While dealing with legacy variations on long-term products such as mortgages is a fact of life for lenders, he says the benefits of smart product design will lessen the burden internally at institutions as well as provide the best deal for customers.

"The banks that will succeed in the future will [at the design stage] consider the end-to-end impact of a new product: whether customers understand it, how much impact it has on the call centres, how much manual and automated work it needs in the operations centres," he says.

But all those who spoke said there was no way of completely guarding against mis-selling given the scale of the industry and the number of goods it sells.

Yet, for the man on the street, there may be some reassurance in knowing that the scandals brought to the fore in recent years have spurred practical reform, as well as changing the tone at the top.

Analytical tools offer solace in unsure world

Hedge funds

Funds need to know if all portfolio managers are taking the same risks, *writes Dan McCrum*

At its root, the job of hedge fund managers is to take risks by investing their client's money.

So risk management is the start and end point and a manager has many tools to hand: stop losses to close out losing trades, derivatives to hedge against market losses, or long odds bets on disaster to provide insurance against what is known as "tail risk".

Yet, as hedge funds have evolved from one man bands into miniature institutions managing many billions of dollars, the job of assessing what risks have been taken becomes exponentially more difficult.

A firm may have just a few key people making decisions at the top of the fund, or even just one in the case of flagship funds run by marquee managers such as Louis Moore Bacon of Moore Capital, or John Paulson of Paulson & Co.

But with multiple teams of traders and investors operating in several different markets, there can be thousands of interlocking bets in place, and the danger is that a fund may actually be taking the same risk many times over.

For instance, at one end of the spectrum is Millennium, an $18bn hedge fund based in New York that employs 1,300 people round the globe. It has no centralised view of the world but, instead, is a multi-strategy fund looking to make many varied bets in different markets.

A large part of risk management then is making sure hedge funds do what they are supposed to. When new managers are hired, they have to fill out a 17-page "risk survey" which lays out trading strategies they expect to employ, along with their constraints. The survey is fed into Millennium's systems for monitoring subsequent trading.

John Novogratz, global head of marketing and investor relations for the hedge fund, says this is a "trust but verify approach. We want to make sure that they are living in their appropriate box".

The positions for each of Millennium's 145 portfolio management teams are then aggregated by the hedge funds' technology, overseen by 25 specialist risk managers. Any overall portfolio leanings, for instance a long bias on the stock market, can then be hedged.

Fund chief Louis Moore Bacon

The process is designed to detect whether a new hire from a bank trading desk or a rival firm that arrives with a good track record can maintain it without access to the same information, or in a different structure. "Generally turnover happens within the first two years of existence," says Mr Novogratz.

> 'Many got into trouble in 2008 because of reliance on measures of value at risk'

Technology has become key to this sort of risk management. A cottage industry has sprung up to sell analytical tools and systems to hedge funds who must demonstrate "institutional quality" IT in order to receive money from the big pension funds.

Specialised consultants such as RiskMetrics compete with the likes of Bloomberg, the data provider, to help a fund assess its lurking dangers. Large asset managers such as BlackRock, or the hedge fund group Citadel, have started to sell the use of software that they have built internally. No one piece works alone, however.

Todd Builione, chief executive of Highbridge's hedge fund business, says his group "takes a three-pronged approach" to managing the risks of interlocking positions.

The fund can see the contribution of risk from each portfolio, he says, "and we make sure we're sufficiently diversified across decision-makers." Then the fund aggregates all the effects of the inter-related exposures to calculate an overall portfolio position.

The third prong is to "use overlay hedges to counteract those inter-related exposures that contribute excessive risk", he says.

The industry's focus on unintended risks is a consequence of the experience of many funds during the global financial crisis, when managers found that they had far more exposure than they thought to a broad-based financial panic.

Troy Gayeski, senior portfolio manager at the fund of funds group SkyBridge says "a lot of funds got into trouble in 2008 because of an over reliance on measures of value at risk (Var)," a popular statistical technique to assess potential losses.

He says the first question you have to ask is what is the "look-back", the amount of historical information feeding into that calculation of Var. In 2008, many of those assumptions proved too optimistic.

"Its a useful measure but you also have to stress test the portfolio to gauge the potential effect of crisis events such as the fall of 2008, the summer of 2003 or 1994, when interest rates rose sharply, and the Asian and [the] Long Term Capital Management crisis of 1998."

That LTCM failure provided a foretaste of what was to come. After four years of spectacular profits produced by applying large amounts of leverage to arbitraging small differences in the price of securities, such as government bonds, markets moved against the LTCM's mathematical models. The Federal Reserve Bank of New York organised a bailout.

For hedge fund managers, risk management remains a balancing act. Mr Gayeski says: "if you just focus on the worst possible outcomes then you won't take any risk at all. The job of a hedge fund manager, after all, is to decide where and how much risk to take."

Emerging markets need greater due diligence

Misconduct and fraud will only be picked up by those businesses that make the time to carry out thorough checks, reports *Paul J Davies*

Beijing blues: Caterpillar's failure to delve deeply cost the company millions of dollars AFP

Caterpillar of all companies ought to know a thing or two about digging. Even the world's best known maker of mechanical shovels and earth movers, however, appears to have been caught out by not doing its digging properly in China.

The company's $580m writedown this year on the value of a mining equipment maker bought just 18 months before has thrust the issue of corporate digging into the spotlight.

Caterpillar said it had uncovered multi-year accounting misconduct in the months after it bought ERA Mining for about $800m, which had led it to write down the value of the deal so dramatically. The main problem identified was typical of those seen at many Chinese companies where misconduct, or even fraud, is alleged: recorded inventory was not there.

In an industry where the main product – roof support systems for mine shafts – measures several meters in each direction and weighs multiple tons, most people would imagine it would be tricky to mislay one, let alone several of these. In one of the most famous examples of missing inventory in China, the idea that Sino-Forest could turn out not to have vast tracts of woodland it claimed to have, would have seemed unbelievable to many beforehand.

Yet in China as in some other big promising emerging markets, things can often be difficult to decisively nail down.

Jamie Sparkes, head of transaction risks in Asia for Marsh, the insurance broker, says these sorts of problems can be all too common. "There's always going to be questions over the legal framework of deals and the quality of access to data," he says.

The other side of the coin is that acquisitive companies themselves are often not doing enough to dig into what is – and is not – there.

Robert Morris of Alix Partners, a forensic accountants group, says that private equity firms have historically always negotiated very strongly in terms of the due diligence work done in China, but that is still commercial due diligence – or straight forward studies of profit and loss statements and balance sheets to ensure they make sense.

"There is little real drilling down to check the validity of the statements fundamentally," he says.

Among companies looking to acquire businesses in China, the amount and type of due diligence varies greatly. "One bank client asked us to do a very in-depth investigation of a company for which they were just sponsoring a bond deal," Mr Morris says. "Others are still not doing much more than the very basics."

"Given the examples of problems emerging, companies ought to know they cannot afford to go into these deals with their eyes wide shut."

There have even been examples of companies asking some investigators to look into a target on the basis of earning a success fee – if there are no problems and the deal goes ahead, the investigators get paid – which somewhat skews the incentives.

Part of the problem in all emerging markets is the gap in working, business and accounting cultures generally, some experts say.

Charles Ching, a partner at Freshfields in China, says companies or individuals investing in a place like China need the full background information on a country and the people involved in a deal to know what they are looking at and what to look for.

Also, the competitive nature of deals when markets are hot means companies do not always have the time for in depth due diligence. "In developed markets there is a more established framework – in terms of how a deal is done and what is the process – that gives companies this time," says Mr Ching. "In China and other developing markets, international buyers are often competing against local buyers, who may have very different risk tolerances."

His Hong Kong-based colleague, Geoff Nicholas, adds that an acquirer might have legitimate reasons to be less concerned about the existing business. "A company might actually be buying a business not for its existing book, but for the platform it can provide to sell the buyer's products into a new market – in this case the current books may be less relevant," he says.

Like in most things it is very difficult to avoid the determined fraudster. That is part of why buyers of businesses ask for warranties from a seller over things like title to shares, the status of the company and the key contracts it has. And, if you cannot be sure of the strength of such warranties, one of the things you can do is buy insurance.

'There is little real drilling down to check the validity of the statements fundamentally'

Anthony Butcher, who leads the Private Equity and M&A Services in China for Marsh, says the use of indemnity insurance to cover such warranties is on the rise in Asia. "We have seen as many inquiries for this in the first three months as in all of 2012, showing that awareness of this cover is definitely growing," he says.

Such insurance can even make a company's bid more attractive than a rival's, because it will demand less of the seller in terms of the level of indemnity to the buyer it will be asked to provide, or the length of time it will be asked to hold the proceeds of a sale in escrow just in case things turn out to be not what they seem.

But, insurance is a last resort. Nothing beats making sure there is time to dig as deeply as possible.

Unconventional asset classes widen their appeal

Hunt for yield

Pension schemes play riskier game, writes *Jane Croft*

As interest rates remain low, traditionally risk-averse investors, such as pension funds, have increasingly been turning to unconventional classes of assets like property, commodities and high-yield bonds in a relentless search for yield, driven by pressure on the target returns needed to cover liabilities.

In its 2013 Global Pension Assets study, Towers Watson, the professional services company, found that in the seven largest pension markets, equities, bonds and cash allocations had been reduced to varying degrees. Assets in alternatives such as property had grown from 5 per cent to 19 per cent since 1995.

John Ralfe, an independent pensions consultant says that, traditionally, the UK and US defined benefit pension funds held about 80 per cent of quoted equities, and the balance in bonds and property.

"This seemed to work well in the bull market of the 1980s and 1990s, with company sponsors able to make modest annual contributions to pay for new pension promises, which invested in equities, then magically grew in value," he adds.

"But, the end of the dotcom boom in 2000, coinciding with the introduction of the new UK accounting standard, FRS17, bringing pension deficits on to company balance sheets for the first time, showed this was no more than a 'magic money tree'."

He adds that since then there has been a desperate hunt for the 'next new big thing' to plug pension deficits. "Including hedge funds, private equity, commodities, foreign currency and property – made more desperate by the low interest rates of the last couple of years. This hunt diverts from the real issue – deficits can be plugged only if the company gets out its cheque book and puts more money into the scheme."

Last year research published by Pyramis Global Advisors, the asset manager, suggested that pension funds were gloomy about achieving the target returns they need to cover their liabilities over the next five years. This was driving more than half of global investors to rethink their asset allocation, with 38 per cent planning to increase their use of illiquid asset classes such as real estate and infrastructure.

Andy Green, partner and chief investment officer of Hymans Robertson, the independent pensions consultancy, said many pension schemes have sold down gilts and invested in corporate bonds, high yield and emerging market debt where, until recently, yields had been more attractive.

More recently floating rate loans had also become attractive. He says: "The rotation has been from gilts to corporate bonds and now from short-dated corporate bonds to floating rate loans where you get better yield and are immunised if interest rates rise, as the coupon rises as well."

But the change in asset allocation brings risks.

While investing in property, for example, provides diversification of a fund's assets and can help reduce risk in a portfolio, it is intrinsically illiquid, and owning property requires large amounts of capital to have a diversified portfolio.

'We have seen a desperate hunt for the "next new big thing" to plug pension deficits'

Infrastructure projects are being seen as attractive but opportunities can be difficult to come by.

"Pension funds also like the regular inflation-linked income stream provided by infrastructure but it can be harder to access this without buying the underlying equity of the companies, which is still equity and behaves like equity," says Mr Green.

Other assets carry risks and the UK government's actuary's department issued a note of caution on high-yield bonds last year.

Mr Green says diversification still carries risks. "There is a broader risk of illiquidity and whether assets can be sold if the markets freeze up as they did in 2008, although most pension funds can actually benefit from extra yield in return for this illiquidity, and there can also be concentration risk as many strategies necessarily involve active management."

Alasdair Macdonald, head of investment strategy UK at Towers Watson, says as funds take more investment risk, they have ways of helping manage that risk. "They can take out risk elsewhere by reducing longevity risk for example. Or, if they are better funded, then this may offset some of the downside risk from investing in riskier assets.

"They can purchase options so if, for example, they buy equities they can buy put options to protect against equities falling to offset any downward risk."

Many believe risk can be managed by using trigger points so a pension fund can sell positions if a certain market price is reached.

Mr Ralfe says companies continue to take financial risks in their pension schemes which they would not dream of taking on in their treasury departments.

"They need to be able to answer three simple questions 'What can go wrong? How quickly can it go wrong? What do we do if it does go wrong?'".

Complexity slows pace of watchdog

Lobbying

Policing global and tangled financial operations has proved difficult, writes *Jane Croft*

Robert Jenkins: Bank of England Financial Policy Committee member issued warning

Ever since the financial crisis of 2008, when the enormous risks undertaken by the banking sector in the boom years first became apparent, financial regulators have been trying to make the system safer and more resilient.

Calls for tighter financial regulation have only grown louder as other controversies have engulfed the sector, notably the Libor interest rate setting scandal and anger at bankers bonuses.

But, five years after the crisis, the pace of regulation has been slow, partly because of the complexities of imposing rules across many countries.

There have been accusations that the powerful banking industry has been so influential in its lobbying that regulation has been watered down in a number of areas.

In the past decade the finance and real estate industries more than doubled spending on lobbyists, reaching $474m in 2010, according to the Center for Responsive Politics in Washington DC. Since 1998 they have spent more than $4.5bn. Certainly the lobbying tactics of the banks have had their fair share of critics.

Robert Jenkins, who is on the Bank of England's Financial Policy Committee – tasked with protecting financial stability – made a speech in 2011, warning that bankers' efforts to water down tougher new regulations by claiming they will harm economic growth was "intellectually dishonest and potentially damaging". "A profession which should stand for integrity and prudence now supports a lobbying strategy that exploits misunderstanding and fear," he said at the time.

Research has also been published which has shown that lobbying in the boom years was associated more with risk taking.

An IMF report published in 2009 found those banks which spent the most on lobbying performed the worst, expanded their loan books faster, made riskier loans and had more loans go sour. The IMF Working paper A Fistful of Dollars: lobbying and the financial crisis by Deniz Igan, Prachi Mishra and Thierry Tressel raised questions about the role of lobbying. The report – the first to look at lobbying and the financial crisis – concluded: "Our analysis suggests that the political influence of the financial industry can be a source of systemic risk."

However, some commentators believe that the regulatory changes being proposed are so radical that bank lobbying and engagement is important.

'Political influence of financial industry can be source of systemic risk'

Etay Katz, regulatory partner at Allen & Overy, the law firm, says: "The banking community has rightly been engaged in intense lobbying as, since the financial crisis, there has been the most radical and drastic regulatory reform agenda seen in recent history. That reform is backed up by a strong political desire to eradicate all risk from the system.

"Banks need to choose their targets carefully, as on some topics, the most ferocious lobbying on issues like retail ringfencing banks in the UK will not necessarily change policy, but in these cases the debate is focused more on the margins and on the detail of technical issues, such as capital liquidity or the time frame for implementation for example.

"If banks need to see their tier one capital ratios rise from 7 per cent to 12 per cent over two years or over five years that makes a huge difference to the banks concerned." he says.

Much of the recent lobbying activity has focused round Basel III banking rules which many banks have complained are too onerous and about which there has been intense lobbying for years.

When the Basel Committee on Banking Supervision, which sets international rules which local regulators follow, unveiled its Liquidity Coverage Ratio rules earlier this year, for example, the changes reflected years of lobbying by the banks that the LCR could limit their ability to lend.

The new rules aim to ensure individual banks hold enough cash and liquid assets to allow them to survive a short-term crisis.

The draft rules specified that only government bonds and top quality corporate bonds would count toward the buffers because they were the only truly safe assets. But the industry lobbied hard to get the rules watered down, arguing that banks would be too vulnerable to sovereign debt crises, it would cut into bank profits and the banks would be constrained in their ability to lend to the wider economy.

The final version of the LCR published in January 2013 was significantly less onerous than bankers and analysts had expected and allowed banks to count a wider range of assets towards their liquidity stocks and gave them longer to implement the new rules.

Mr Katz says: "The concern with the volume of regulation is that there are unintended consequences. The contribution of lobbying to the agenda is to identify errors or consequences which help legislators and regulators by allowing stakeholders to give context and perspective on what is workable. Lobbying is a vital and legitimate check."

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