Risk Management

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Scandals leave insurers wary of providing cover to banks

Restrictions mean that in many cases lenders are choosing not to buy policies, writes *Alistair Gray*

From an earthquake destroying the global headquarters to a rogue employee committing a sophisticated fraud, some of the biggest threats to companies can be mitigated with insurance.

But for many of the world's largest financial institutions, this most fundamental tool of risk management is increasingly unavailable.

After the financial crisis and subsequent series of scandals resulting in multibillion dollar fines and legal settlements, insurance companies have grown more nervous about providing important types of cover to big banks.

"Insurers want to make it attractive for buyers, but only if it's a sustainable line of business," says Gerard Bloom, chief underwriting officer for financial institutions at the New York-listed insurer XL.

Large banks struggle to purchase protection for many of their biggest operational risks at sensible prices, even though the market for insurance in other sectors is as competitive as it has been in years.

Premiums for big areas of insurance, such as natural catastrophe reinsurance, are at their lowest levels in a decade. A wave of capital flowing to the industry from hedge funds and other investors wanting to generate juicier returns in the face of low interest rates, has kept the market competitive.

To be sure, insofar as they present the same risks as any other type of company, banks have benefited from the plentiful supply of insurance.

Recent scandals such as product mis-selling, benchmark manipulation and money laundering have had little or no bearing on some of the risks they pose. To take an obvious example, a bank branch is no more likely to be flooded than a factory.

In other ways, however, banks pose bigger risks than most businesses because of their sheer size, the complex nature of their business and scrutiny by regulators.

Many of banks' largest potential exposures are uninsurable. In several markets including the US, regulators prevent companies from buying insurance against fines on the basis that it could encourage reckless behaviour.

That does not stop insurers from being able to cover other expenses, such as legal defence costs. Despite having surplus capital, however, the insurance industry remains sceptical about deploying it to cover banks.

The most acute shortage is for professional indemnity (PI) insurance cover for US-exposed banks. PI, known in the US as errors and omissions, covers companies for legal costs and other expenses when a client claims it has suffered because of mistakes or negligence. For a bank, this could be anything from a failure to execute a transaction because of an IT failure, to a hedge gone wrong because data were entered incorrectly.

Insurers have been nervous about such coverage to US-exposed banks since the dotcom boom, when capital markets advisers were accused of artificially stimulating demand for technology IPOs.

However, their concerns about PI for banks have become even more acute since the 2008 crisis and series of subsequent scandals. As well as the sheer size of the potential exposures at individual institutions, the sector's misdemeanours have highlighted its interconnectedness.

Siobhan O'Brien, head of financial institutions at insurance broker Marsh, says episodes such as foreign exchange rate rigging and the mis-selling of payment protection insurance in the UK have had a tendency to implicate several banks simultaneously.

Insurers are cautious about covering closely correlated risks; they make the industry liable for multiple claims arising from the same, or similar, events. "The concern among insurers is the systemic risk," Ms O'Brien says.

PI policies tend to pay out only when sufficient controls have been put in place but not adhered to. They will generally not pay out when adequate systems and practices were not established in the first place.

> 'The big losses that some banks might want covered cannot now be covered'

"We provide insurance for errors; shareholders provide insurance for business risks," as one leading financial institutions underwriter says.

Still, when a blunder or oversight at a bank triggers a claim for compensation, legal costs alone can easily run into hundreds of millions of dollars.

Even though banks have been trying to clean up their businesses since the crisis, which should make them better risks, insurers have been tightening policy wording, increasing premiums and reducing maximum payout levels.

As a result large banks typically pay several times more for PI than other similarly sized companies in other sectors. More importantly, the upper limits mean large banks struggle to purchase cover that will indemnify them for costs above $400m a year, even though underwriters typically club together to cover any one institution.

That is a tiny proportion of the bills large banks are facing. In many cases they are not even adequate to cover legal defence costs. The situation is such that several large banks have decided against buying any professional indemnity cover.

"Some of them have taken the decision not to," says Mr Bloom, "because the big losses that they might want covered can't be covered." He says the trend has moved from US banks to some of the UK and continental European banks.

Other financial institutions — smaller banks, asset managers and stockbrokers — are not facing the same problems, since they do not present the same risks.

Even for the largest banks, insurers are more willing to provide other types of cover. Ms O'Brien notes that the market for financial institution crime insurance is "vibrant".

Large banks would typically pay for thefts that cost them up to $10m themselves, but they turn to insurance for the heavier losses which can run into hundreds of millions of dollars from any one incident.

Still, as armed hold-ups become a thing of the past and give way to sophisticated cyber attacks, insurers are growing wary about their exposures to banks' IT systems.

Another area that insurers have been scrutinising is directors and officers insurance, which covers the costs to senior managers and board members of becoming embroiled personally in legal action. Shareholder litigation has put executives and board members at increased personal risk.

Risk specialists conclude that banks should be worrying more about improving controls than their ability to buy insurance.

As one of the puts it, the key is to do "the right thing for customers rather than trying to minimise the financial impact to the organisation".

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Predictability now trumps excitement

Hedge funds

With their eye on lower volatility, institutional investors appear willing to target lower returns, writes *Miles Johnson*

If 20 years ago, the typical hedge fund client was an ultra-wealthy individual seeking exciting returns, today it is more likely to be a middle class retiree who may not even know that he or she has any exposure to hedge funds at all.

The super-wealthy were willing to accept large risks to generate large returns. Hedge funds are now increasingly vehicles for pension funds seeking to diversify from "traditional" holdings such as stocks and bonds.

Pension funds account for more than a third of assets managed by the hedge fund industry. A high proportion comes from politically sensitive state-run pension funds that are concerned about how they are charged fees and how their investments are run.

At the same time, in a low interest rate environment when many European government bonds offer investors negative returns on their money, pension funds seek less high-octane performance from their hedge funds than was once expected from the industry.

Predictability has replaced a desire for risk.

"Institutional investors are now prepared to target lower returns from their hedge funds, with lower volatility, than in the past," says Daniel Caplan, European head of global prime finance at Deutsche Bank.

In a recent Deutsche Bank survey, only 14 per cent of responding investors said they targeted returns of more than 10 per cent in the coming year for their hedge funds; 37 per cent had sought double-digit performance in 2014.

This relatively new-found conservatism among investors such as pension funds has had an impact on how hedge fund managers approach investing.

In the post-financial crisis years, the amount of borrowing hedge funds were able to take on to buy investments shrank and investors in general were reluctant to place money with any fund that had misbehaved before the crisis.

This has meant that the turbocharged hedge fund culture of pre-2008, where some funds used huge multiples of leverage, has been replaced by larger, far more institutionalised hedge funds that emphasise risk management in their sales pitches.

Some hedge funds have significantly developed their asset bases in the post-crisis years after winning the confidence of the pension funds. Yet it might be argued that this incentive to accumulate client assets, on which a lucrative management fee can be charged, has meant that there are large hedge funds that have not delivered the investment returns for which they are paid.

Alper Ince, a managing director at Paamco, a California-based fund of hedge funds with $9.5bn of assets and which specialises in investing in start-up hedge funds, says size can hinder a manager's ability to generate large returns for clients. As such, it is mainly when managers are starting out that they are incentivised to take on the right balance between generating high returns for their clients, and making sure they do not lose money.

Paamco managing director Alper Ince: 'Investors are looking for differentiated sources of returns'

"One of the reasons we are focused on small managers is because at the start they are in performance-generating mode," says Mr Ince, contrasting this with managers who already have large asset bases and are unwilling to take risks that could damage that position.

"In a low-return environment, investors are looking for differentiated sources of returns. They may want a little bit more concentration instead of a diversified fund where things cancel each other out."

Another way in which hedge funds have been able to allow investors to take on more concentrated bets on particular ideas is to establish so-called managed accounts, in which they can make investments alongside specially chosen clients.

These accounts have allowed some hedge funds to offer clients chances to invest in potentially lucrative trades that may take a longer time to pay off, such as bets by several managers in recent years on the recovery of US mortgage-backed securities.

But other hedge fund managers leave their larger employers in order to establish smaller, nimbler investment groups that are better able to seize opportunities quickly.

"Some of the managers that are leaving big hedge funds to start smaller ones, do so because they think they cannot take meaningful positions where they are currently, given the significant asset base they are working with," says Mr Ince. "They want to run more concentrated portfolios."

Yet most hedge fund managers remain aware that their institutional investors will probably only remain willing to accept lower returns while interest rates, and returns on other investments, remain low.

As soon as rates begin to rise, the desire for the double-digit gains once seen as the industry's standard is likely to reawaken.

Cyber crime thrives on cost-cutting culture

Security

Digitisation and consumer demands for more efficient banking heighten the threat, writes *Emma Dunkley*

Hacked off: big banks are worried

The concept of stealing money from a bank used to call up images of armed robbers breaking into a building to raid tills for cash.

The reality now is that theft is largely undertaken by sophisticated hackers breaking into the digital channels of banks and their customers. As lenders open more digital routes through which people can bank, hackers have more pathways to target to siphon off money and steal customer data.

The threat of cyber crime is pernicious. The Financial Conduct Authority, a UK regulator, has even been warned about loopholes in the cyber security of one of Britain's largest banks, which could compromise the accounts of millions of households and businesses. Yet pressure to cut costs pushes banks to close branches and digitise, spurred on by consumers demanding more efficient banking access.

Figures from the British Bankers' Association show there were 18.6m mobile app uses a week on average in 2013, more than double the amount in the previous year.

The threat of cyber crime is heightened by the increasing move to digitisation, says Nicola Crawford, a board member of the Institute of Risk Management. She notes that banks often have to rely on third-party systems in order to provide a number of their new digital services.

She adds: "Whether it is external data feeds, customer and staff devices or cloud services, banks find themselves having to adapt to relying on systems that are outside their control."

However, while banks have

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Regulators push banks hard on capital ratio flexibility

Weighted assets Watchdogs appear increasingly keen on the letter of the law, writes *Laura Noonan*

The public debate on banks' capital ratios has long focused on the "top" number, namely homing in on the billions in capital that banks have and how they can go about increasing it to satisfy regulators' demands for ever higher capital ratios.

A far more interesting debate has been bubbling under the surface, focusing on the "bottom" number, the yardstick against which banks measure their capital to get that all-important ratio. And it is about to come to a head.

That yardstick in the line of fire is "risk-weighted assets", or RWAs, which are an expression of how risky an asset is considered to be.

A $100,000 mortgage could have a risk weight of 30pc, so its RWA figure is $30,000. You need $3,000 of capital to have a 10 per cent capital ratio against the $30,000; but if the risk weighting were 40 per cent, you would need $4,000.

As things stand, banks can calculate their RWAs using "standardised" risk weights set by the international regulators, or they can choose to create their own models and use those instead.

Those internal models spit out strikingly different results, a fact that has not gone unnoticed by regulators, including the Bank of England and the global banking watchdog, the Basel Committee.

Pressure to reduce those discrepancies — which can make the difference between a bank being able to pay a dividend and having to raise extra capital — is mounting on multiple fronts.

Regulators across the globe, who were always responsible for reviewing banks' internal models, have become increasingly vigilant in the past year, and industry insiders say some banks have taken a more "conservative" approach to modelling.

"Tolerance has gone down," says Stephen Hall, a London-based partner at KPMG. "Regulators are much more keen to see if the organisation is applying the letter of the law."

The European Central Bank, newly empowered as the eurozone's pre-eminent banking supervisor, has sent a shiver down banks' spines by embarking on a review of RWA calculations across all banks under its supervision.

The review follows hard on the heels of the ECB's Comprehensive Assessment on whether banks were valuing their assets properly and were strong enough to cope with another financial crisis. Some 25 of the 130 banks examined failed the assessment.

"European banks generally acknowledge that RWAs will rise as a result of the review," says Jon Peace, bank analyst at Nomura. "The ECB is very keen to see some harmonisation."

At the global level, the Basel Committee has put out a consultation paper proposing to make standardised risk weightings more nuanced, and suggesting "floors" for banks' own models.

If floors were introduced, regulators could declare that modelled RWA exposure cannot be less than, say, 75 per cent of the standardised result.

Analysts from Barclays wrote in a note on March 2: "These proposals are quite radical and could have a profound impact on capital adequacy, dividend payouts and the earnings power of different business models."

They believe banks' common equity tier one (CET1) ratios — their key capital target — could fall by as much as 1.4 to 2.7 percentage points, depending on the Basel Committee's findings.

International rules require banks to have a CET1 ratio of at least 4.5 per cent. Regional and national regulators can set higher thresholds, and banks usually like to have a CET1 ratio of about 10 per cent so they can assure investors they are "well capitalised".

In their research, the Barclays analysts focused on RWAs for credit risk, a category that covers the loans and other credit commitments that make up 81 per cent of the total RWAs across the banks studied.

Mr Peace says the impact of the international review will probably be most pronounced for investment banking, which relies more heavily on internal models than retail and commercial banks.

Calculations from investment banking research firm Tricumen show how greatly RWAs in investment banking vary. Tricumen looked at the relationship between RWAs and revenue across eight key business lines for the top nine global investment banks.

'There could be profound impact on the earnings power of different business models'

In the cash equities business, it found that one bank had RWAs equal to 16 per cent of revenue. At the opposite end of the scale, another bank had RWAs equal to 5 per cent of revenue.

In foreign exchange, the discrepancies were more modest, with one of the lowest RWAs at 2 per cent of assets and the highest at 5 per cent, across the banks Tricumen analysed.

"Banks are definitely optimising RWAs and we certainly see different treatments," says Seb Walker of Tricumen, adding that banks' results could also vary depending on which assets they put in their trading book and which they held in their banking book. Trading and banking books attract different RWA treatments.

Mr Walker says a gap is developing between those banks that had invested in group-wide risk systems and those that had not. Banks with sophisticated group-wide models are better placed to create models that will reduce RWAs.

While banks have done a lot to improve their models and achieve lower risk-weighted assets in the past, most experts say banks are no longer focusing attention on this area, and are instead preparing for a more constrained world.

"There's a general acceptance that banks will have to use the standardised approach with floors, but not for a few years," says Mr Hall.

Banks are not expecting to see the Basel Committee's final proposals until the fourth quarter of 2015. They are likely to be given several years to implement any new requirements.

The timing of the ECB review is unclear and some banks think it could take years to carry out comprehensively. They also face another constraint that means the gains from low RWAs are not what they once were. Regulators across the globe are introducing a new measure, dubbed the leverage ratio, which restricts banks' abilities to use models that reduce the amount of capital they are required to hold.

The leverage ratio means banks hold a set amount of capital relative to total assets, regardless of how risky those assets are. Regulators say they still like the theoretical basis of using RWAs to calculate capital ratios as they were introduced to reflect that different banking assets have different risk profiles and different level of likely losses.

Mr Hall says the UK authorities are still approving new models and not just for big banks. Principality Building Society, a UK deposit taker with a balance sheet of £7bn, had an internal model approved in late 2013. "There's no restriction. The regulator will still allow modelled approaches," says Mr Hall.

Basel's world: consultation suggests 'floors' for banks' own models
Dreamstime

Passive funds' rise heightens fear of shock to system

Investment styles

Trackers gain in popularity as disappointed investors ditch active managers, writes *David Oakley*

In the past two years, the growth of passive investment funds, which track the markets and charge cheap fees, has been one of the main stories in the world of asset management.

Last year Vanguard, one of the world's biggest providers of passive investments with $2tn in trackers and more than $450bn in global exchange traded funds, was the most popular mutual fund management group globally. It had more net inflows, a fifth of all new business, than more than 3,000 groups tracked by data provider Morningstar.

There is no big secret to the group's success. As Tim Buckley, chief investment officer of Vanguard, says: "We charge low fees and offer value for money. Active managers charge much higher fees and often still struggle to outperform our passive funds."

The US mutual group levies an average expense ratio on its funds in the US of 0.19 per cent and 0.23 per cent in Europe. That compares with a typical expense ratio on an actively managed fund of 0.75 per cent before trading costs.

Yet, despite what seems a success story for Vanguard and other big passive providers such as BlackRock and State Street Global Advisors, which were also popular with investors and attracted big inflows last year, there are question marks over the systemic risks they might pose to the system.

In short, as they track the markets, they create a herding or momentum effect, which can exaggerate rises or falls in the stocks, bonds or commodities that they track. If the entire market has to move in one direction because investors are trading passively, then the obvious problem is not knowing who is on the other side of the trade. Who will do the buying when the passive funds are selling and who will do the selling when the passive funds are buying?

Vanguard and BlackRock alone have more than $7tn in assets under management, of which a large chunk is in passive products. This means that a vast amount of money is going one way in response to economic announcements, external shocks or political decisions that are considered important for investors.

But passive investment may not yet big enough to create the systemic risks some might fear.

In the US, where Vanguard launched the first index tracker in the 1970s, passive investment accounts for 30 per cent of the market. Active investment, where managers select stocks that they think will beat the market, accounts for 70 per cent. In Europe, the ratio is 90 per cent active management and only 10 per cent passive.

'Active managers have to make the case rigorously for what they are charging'

Passive is likely to make more inroads into active management in the UK and continental Europe, but it is thought unlikely to steal much more than 30 per cent of market share in the US. Active managers are likely to dominate the investment universe, at least for the foreseeable future, say investors.

Stephanie Flanders, chief market strategist for UK and Europe at JPMorgan Asset Management, says: "The move towards passive is entirely understandable as clients were not getting what they paid for with some active fund managers. Passive investment is likely to grow in Europe. Active managers have to make the case more rigorously for what they are charging."

Stephanie Flanders: 'active is best'

But she thinks active management still offers the best option for many investors. JPMorgan Asset Management, an active house, was the third most popular mutual fund manager globally last year behind Vanguard and BlackRock — proof that clients are still prepared to pay extra for an active manager they think can provide alpha, or beat the market. Goldman Sachs Asset Management, another active manager, was the fourth most popular mutual fund manager.

Michael Dobson, chief executive of Schroders, the active UK listed group, says: "Passive investment has a place, but we have shown that we can attract and retain clients on the basis of our strong products and strong performance.

"You cannot beat the market every year, but if you can show that incrementally you can outperform, then clients will choose active managers. That means over a long period you need to produce better returns, which we have shown we can do."

Last year, Schroders won £24.8bn in new business and 78 per cent of its assets under management outperformed over three years. Other active European houses such as Henderson Global Investors had a good 2014, too.

Schroders particularly has shown that an active management business can beat all competition with the right fund managers, executives, brand and distribution network. It has just declared record pre-tax profits for 2014.

A strong case exists, therefore, for buying both passive and active investments. As long as active management continues to dominate, that should damp fears that passive managers might become a systemic risk.

Transactions insurance gains in prominence as deal activity picks up

Mergers and acquisitions

Warranty and indemnity cover can aid the completion of some tricky discussions, writes *Arash Massoudi*

For decades, capital markets have facilitated corporate takeovers by providing deal financing. But markets that help buyers and sellers to gain protection — or at least greater certainty from the unforeseeable following a deal — have struggled.

This is changing. The upswing in deal activity in recent years has been accompanied by a rising number of insurance policies for either a buyer or a seller.

The policies, which are created with the help of specialist brokers and underwritten by large insurers such as AIG, are becoming prevalent in deal talks, practitioners say. Designed to shift liabilities to a third party, the presence of so-called warranty and indemnity (W&I) insurance is aiding the completion of tricky discussions.

"In difficult negotiations over the scope of buyer protections, W&I insurance is increasingly being used to bridge the gap and get deals over the line," says Ffion Flockhart, partner at Norton Rose Fulbright.

While much attention in a transaction is paid to its price and terms, less well understood is the process by which buyers and sellers agree on the specific conditions regarding the asset changing hands. In a typical negotiation, a seller is supposed to provide thorough disclosures about the asset and makes promises — warranties — about those disclosures, which last for a set time.

If a buyer finds any of those statements — that cover anything from shares to intellectual property — were false, it may be entitled to seek damages, even if years have passed since the deal was struck. A seller makes certain commitments to make good on a buyer's future losses, known as indemnities, in case of unforeseen circumstances. Thus the most common forms of risk insurance are policies that cover these warranties and indemnities.

These bespoke policies are tailored to cover either a buyer or a seller in a deal for post-closing liability. A seller, for instance, that wants to limit its future liabilities following a deal, may purchase this insurance to potentially shift that liability to a third party insurer.

That has been particularly attractive for selling shareholders looking to retire or for companies who need to protect their balance sheet from potential claims arising out of previous disposals.

But the real growth has been in buyer policies, with private equity being a significant force in driving increased demand. A survey from Allen & Overy found 17 per cent of European private equity deals included some form of W & I insurance. Private equity or institutional sellers typically look for a clean break when they sell companies, so that their sale proceeds can be returned to their limited partners.

'Dealmakers have used the product and are becoming more comfortable with it'

This is no longer acceptable for most buyers, who are increasingly using insurance policies to ensure they can recoup any liabilities, says Nuala Read, a London-based director in the M&A practice at insurance broker Aon. She says: "We have seen the amount of buyer W&I policies increase fourfold since 2010, as this insurance product has been increasingly useful for private M&A transactions."

W&I: liabilities shift to third parties

Marsh, another broker, says the use of insurance policies around deals is growing. In 2014, it placed limits of $7.7bn, up 51 per cent from a year earlier. Daniel Max, a managing director of private equity and M&A at Marsh, says the policies are filling the void where capital markets struggle to understand contingent deal-specific liability.

He says insurance companies are generally bad at working with single issue credit risk "so what we are doing is exploiting the arbitrage where an insurer is well positioned to provide some deal certainty by ringfencing known risk issues".

So why has the market for these policies grown so quickly in recent years? Mary Duffy, head of M&A at AIG, says she has been working on the product since its infancy in the late 1990s, when acquirers complained that the insurance was too expensive to be used: "One of the main reasons we are seeing increased adoption of insurance is because pricing has come down.

"Also, we have hit the critical point where it has gained enough credibility so that dealmakers have used the product successfully and are becoming more comfortable with it," Ms Duffy adds.

Underwriters say they have compiled sufficient data to study loss trends over time, allowing them to reduce the cost of policies.

There are risks, however. The insurance is designed to cover unexpected issues after a deal, but relies on a buyer doing thorough diligence of the asset and the seller providing full disclosures about it.

"Our biggest risk is that adoption of the insurance will change the behaviours of parties in negotiations and due diligence. So we look closely to see that there has been a balanced, negotiated agreement and that due diligence has been robust," says Ms Duffy.

Nonetheless, "there seems to be no slowing down" in demand, adds Aon's Ms Read. "It is a very exciting time for the M&A insurance world."

Clever LeapFrog keeps portfolio one jump ahead

Emerging markets Best due diligence may not end when deal is signed, reports *Joseph Cotterill*

Once upon a time in South Africa, being HIV-positive effectively meant you were uninsurable. That was until 10 years ago, when one life insurer began to offer regular medical tests alongside its policies.

In doing so, AllLife became the world's first company to sell whole-life insurance cover to people on low incomes with HIV. Its "continuous underwriting" has since helped its clients measure and manage their health as well as helping it to price its products.

This makes AllLife a success story for investment by private equity in emerging markets as much as being clever risk management. The company is one of the holdings of LeapFrog, a fund that has backed fast-growing African and Asian financial services since 2008. Bima, another of its companies, works with network operators to sell microinsurance through mobile phones.

However, it may be the clever risk management — including LeapFrog's wider approach to monitoring governance in its portfolio companies — that most interests other private equity companies also looking at buying unlisted assets in emerging markets.

The best forms of due diligence may be those that do not end when a deal is signed and which are as diligent socially as they are financially. It might also help raise returns, as private equity firms sell companies to corporate buyers who increasingly value governance in emerging markets.

LeapFrog, which raised its latest, $400m fund last year, may admittedly have a rare perspective in its industry.

It invests its backers' money for "profit with a purpose", delivering high returns while aiming to bring effective, affordable insurance to millions of low-income consumers for the first time. The company says its 2008 target of reaching 25m people in a decade has already been achieved thanks to measuring the impact of portfolio companies on financial inclusion through the course of the investment.

"Our approach is ESG [environmental, social and governance] plus plus, in that sense," says Sam Duncan LeapFrog's head of impact,.

Profit with purpose: aim is to bring insurance to low-income consumers — Reuters

Such ESG factors are being increasingly demanded by investors in standard private equity funds, from pension funds to university endowments, as hallmarks of a good investment.

Also, the weight of private equity capital that has been raised to find returns higher than those in developed markets may mean far greater care will be needed putting it to work. Of $22bn raised by private equity funds to invest in Africa between 2007 and 2014, more than $8bn was raised last year, according to the African Private Equity and Venture Capital Association. Meanwhile, in Asia, the amount of "dry powder" — capital yet to be committed to deals — is well above $129bn.

Many new firms deploying capital are also private equity houses with global franchises underpinning listed entities with billions of dollars under management. Last year KKR, a US-based global firm, made its first African foray by buying a stake in an Ethiopian rose farmer.

Meanwhile, Washington DC-based Carlyle's sub-Saharan fund made its maiden investments in Nigeria and South Africa, respectively stakes in a publicly listed bank and a tyre retailer.

The need to protect global brands is a twist on an old problem for investors carrying out due diligence in emerging markets. Political and reputational risks are very important but hard to gauge.

One common practice when considering investing in Nigerian companies for instance is to check ties to previous administrations, not just the ruling government, given the perseverance of political networks.

A more pressing due diligence challenge may be that many of these buyouts are bets on the rise of emerging consumers. Diligence on a business plan may have to assure companies cannot only expand to reach millions of customers, but also retain their loyalty.

That is where LeapFrog's specialism — combining financial and social due diligence in insurance, an industry where consumer protection is paramount — may prove crucial.

Ms Duncan says: "Unless the customer understands your product, the long-term value proposition for that customer is compromised."

So due diligence may involve looking at tell-tale signs that go beyond financial performance: for a business selling insurance, a healthy — and, depending on the product and maturity, not too low — number of claims is "a key operational indicator, but also shows strong value for customers", Ms Duncan adds.

Renewal rates "are a key leading indicator from a customer retention viewpoint, but if a low-income customer [renews] year after year, it's also strong sign of social performance".

The benefit of measuring this performance throughout the life of an investment may, after all, mean that it fetches a higher price when sold to other investors in emerging markets, which are looking for data and transparency.

Apollo, a LeapFrog investment that tailors livestock insurance policies for Kenyan farmers and others, was sold to Swiss Re last year, for example.

Ms Duncan says: "Due diligence is central, but integrated measurement is the key piece. That's [what is important] in valuations, in being able to measure both financial and social performance."

Cyber crime thrives on cost-cutting culture

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used on specific areas susceptible to cyber attack, Ms Crawford says that multiple systems and processes running in parallel are under threat, which could cause "widespread harm".

Online and mobile payment services form one area where banks are seeking to innovate, while implementing new types of authentication to bolster security.

Royal Bank of Scotland recently unveiled "Touch ID", which allows people to log in to their mobile banking app using their fingerprint.

Thomas Bostrøm Jørgensen, chief executive of Encap, an authentication software provider for banks, says this development marks a "watershed moment" for biometrics in banking.

But he is cautious about raising expectations at a time when "banks are being assaulted by hackers and fraudsters".

"Sure, it's trickier to subvert a fingerprint than a password, but it's not impossible. Touch-ID was 'hacked' less than a month after introduction.

"One hacker has claimed to be able to recreate fingerprints from high-resolution photos. And while you can issue a new Pin or password, you can't issue a new fingerprint — not without it being very messy. A single factor will always be vulnerable to attack."

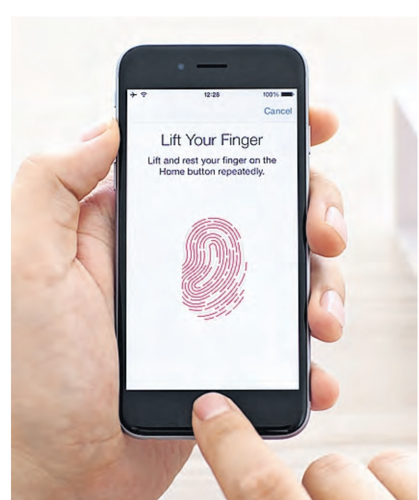
> 'We have seen instances where employees may be manipulating programmes to perpetrate fraud'

He notes how US technology giant Apple suffered reputational damage from a recent iCloud breach.

Large banks in particular face challenges in having to grapple with archaic IT systems. Jonathan Wyatt and Ryan Rubin of Protiviti, a global consulting firm, believe these systems are often so old that parts are no longer manufactured and trained technicians have moved on or retired.

Such banks have been "bolting" on software on top of core systems for years and continue to use platforms that "cannot be secured", Mr Wyatt says.

He adds that there is a realisation in the industry that large banks need to be doing more: "Attacks will become more sophisticated."



Fingerprint ID: a 'watershed moment'

Banks are acknowledging the issue. "The number of security programmes that bankers are running is a strong indicator that they are battling with [cyber risk] as a problem," he says.

Cyber security is on the board's to-do list as a top 10 risk that is rapidly moving up the agenda, he says. Large banks are all extremely concerned.

Aside from cash, hackers might steal customers' data which can be monetised. "There is a value to having information on people's identities, to having credit card details which can be sold on the black market," Mr Wyatt adds.

"We have also seen instances where rogue employees may be manipulating programmes to perpetrate fraud" and of fraudsters using IT to take advantage of the way software is written.

Newer "challenger" banks, unencumbered by old IT systems, might appear more nimble as they have fewer layers of software. But, according to Stephen Bonner at accountants KPMG, not all challengers are using third-party software.

"Quite a few are running off the same back-end systems as the big banks," he says. TSB, for example, was spun out of Lloyds Banking Group and is reliant on its IT infrastructure.

The regulator has even suggested that smaller banks are more exposed to cyber crime.

Anthony Rawlins, senior manager at Moore Stephens, a consultancy firm, says: "The FCA has, quite rightly, concentrated on the increased sophistication of criminals using banks to launder money and move illegal funds internationally.

"Unfortunately, smaller banks do carry higher risks in this regard, simply because of the sophisticated nature of the criminals involved and their smaller internal resources.

"However, much of the preventive action that can be taken is cultural and, if senior management engage, many of the risks can be mitigated and avoided."

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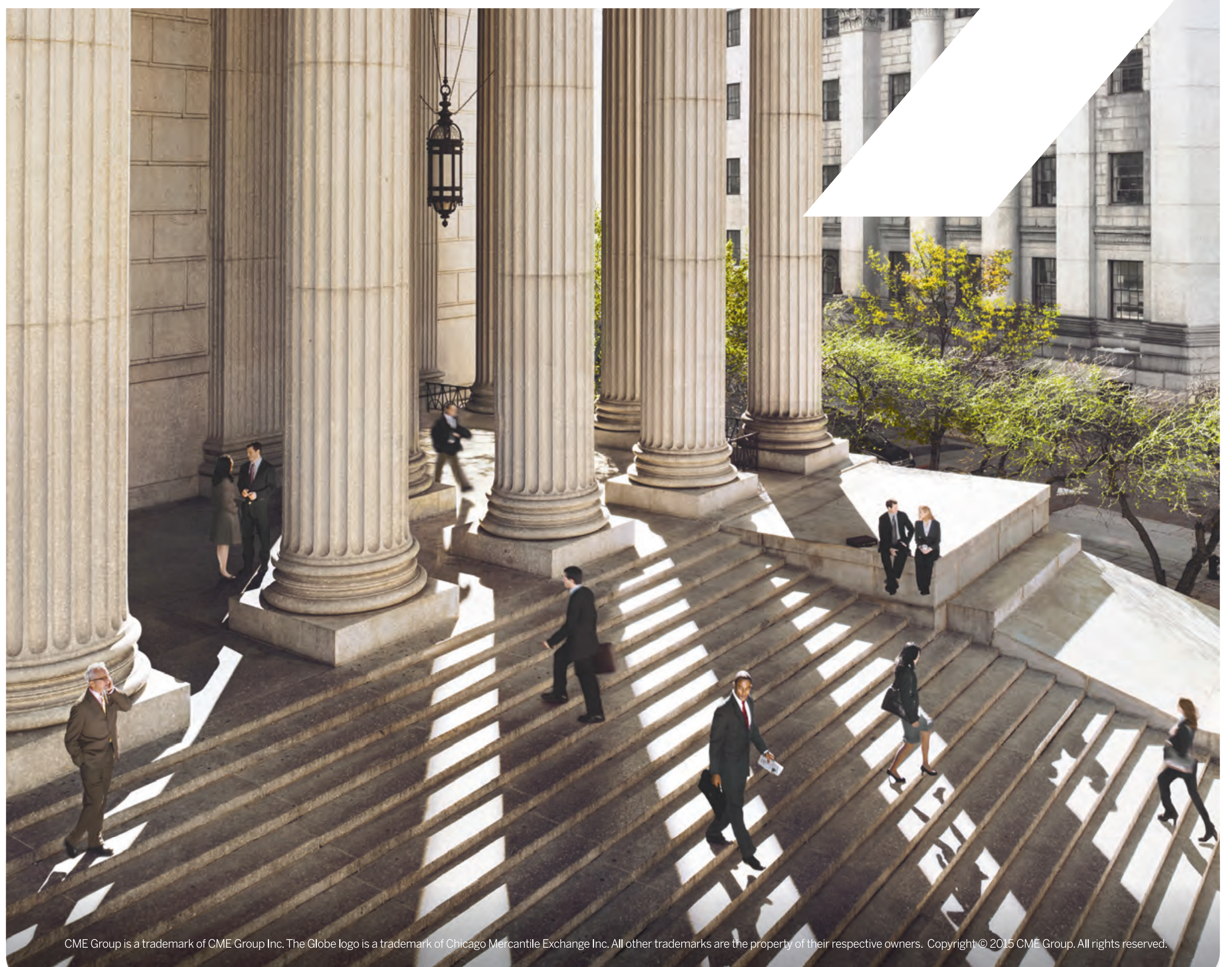

Mediobanca's asset sales help it to fight another day

Business remodelling The once powerful Milanese bank has been transformed, says *Rachel Sanderson*

In journalist's lore, the only way to know when a deal was done at investment bank Mediobanca 20 years ago was to stand outside and wait for the sound of champagne corks popping. Such corporate colour has been consigned to history thanks to the eurozone crisis.

The once very powerful and secretive Milanese bank, which presided over a network of cross-shareholdings making it the top table for Italy's most influential bankers, businessmen and financiers, has been radically transformed.

When the eurozone crisis saw the bank's shares value fall 90 per cent it discovered risk was not outside but inside: the cross-holdings were the veins through which contagion could spread.

The response of Mediobanca under Alberto Nagel, its chief executive, has made it a case study of how to change the risk profile of a business model when the market demands.

In 2012 the price of its shares fell to €2.5 each. Having shed many cross-shareholdings and diversified from being an all-Italian investment bank to a pan-European boutique, Mediobanca's stock now stands at €8.4 per share.

"In recent years both the regulatory and market settings have changed profoundly," says Mr Nagel, who started his career at Mediobanca more than 20 years ago. He is now as likely to be found at its recently expanded 100-person strong base in London's Grosvenor Place as in its Milan's headquarters.

Mr Nagel has also hired senior bankers to expand its presence in Madrid and Paris. He argues that today, being "a specialised bank allows you to have higher and more stable profitability and better proximity to customers than universal banks. Mediobanca's strategy fits this context of increasing specialisation."

Its latest quarterly results support the changes. It reported an 8 per cent jump in revenues to €489m and operating profits of €282m helped by gains on equity disposals. Its fully phased common equity tier 1 ratio — a bank's core equity capital compared with its total risk-weighted assets — was 12.7 per cent.

UBS analyst Matteo Ramenghi says the profits were well above expectations. He says the bank's management has taken "a proactive stance, managing the balance sheet in the new interest rate environment by reducing excess liquidity and bond investments to leave room for loans expansion, and therefore improving asset spreads".

Marco Sallustio, analyst at ICBPI, believes "ongoing recapitalisation of EU banks, the pick of M&A in the banking, telecom and utilities sector, and the flow of new IPOs are expected to provide a decisive contribution to the group's earnings in 2015".

Yet building a pan-European boutique investment bank to compete with the likes of Lazard and Rothschild as it seeks to be "more bank and less holding company", in Mr Nagel's words, has not been without pain.

From 2008 to 2013, Mediobanca made €1bn in writedowns. Having raised €3.3bn from selling holdings in companies such as Fiat and Ferrari, in June 2013 Mr Nagel announced plans to sell another €1.6bn in stakes, a move that would effectively cut its links to many Italian companies. He and his team have since realised €840m with sales of shares in Gemina, Intesa Sanpaolo and others.

It still has a few holdings in industries related to some of Italy's top power brokers, tyremaker Pirelli and cement group Italmobiliare among them.

In terms of historic significance and value, its bigger share sales will come later this year, when Mr Nagel has said he will exit RCS Mediagroup, which owns newspaper Corriere della Sera — a traditional hub of business, financial and political power — and Telco, the holding company of Telecom Italia, by June. Both RCS and Telco had become liabilities with their fortunes tied to weakening consumer demand.

Mr Nagel also plans to sell down 3 per cent of its stake in Generalito take it to 10 per cent to raise funds, possibly to buy a banking business in the UK or Italy. The Generali stake is Mediobanca's most precious — and controversial — asset: about 70 per cent of its quarterly profits came from the insurance multinational. Selling three per cent now would give Mr Nagel nearly €900m to play with.

Analysts say the jury is still out on the destination of Mediobanca's transition. They speculate it may ultimately become a takeover target. But, in the wreckage of the eurozone crisis that destroyed many of Italy's old certainties, Mediobanca will fight another day.

'In recent years, the regulatory and market settings have changed profoundly'

Out in the open: Mediobanca is not the secretive institution it once was Bloomberg

Vigilante researchers wield their swords

Short selling

A new breed of analyst is cutting a swath through the old research hierarchy, writes *Miles Johnson*

In comic books, the masked vigilante carries a double-edged sword as far as the authorities are concerned. The mysterious hero sorts out baddies but operates outside of official control and might even risk breaking the law himself.

The rise of the independent short selling research analyst has created a similar dilemma for regulators and investors. These outfits, often run by anonymous lone wolves, have become in recent years influential voices across geographically diverse stock markets, from London to Hong Kong.

While traditional short sellers — investors who bet against company share prices — have been large hedge funds risking their own capital, the motivations of the research groups can be more diverse.

Some serve as guns for hire, taking on commissions from clients and later publishing their research online. Others invest their own money into their ideas, just on a smaller scale than conventional hedge funds. Others claim a moral imperative for their work, saying they are rooting out corporate fraud conventional investment bank analysts are too conflicted or lazy to seek out.

For traditional fund managers, who have been used to relying on the opinions of investment banks, the ability of a new breed of talented analysts to wipe millions from the value of their holdings armed with only an internet connection and blog has come as a shock.

"This is a new type of risk we need to consider when we invest," says one UK-based fund manager. "The nature of financial markets is changing and the way information and opinions about a company spread is very different to before."

One of the most successful and respected of the short selling research groups is Gotham City Research, named with a nod to the home town of the archetypal masked vigilante, Batman. Gotham, which is run by the research analyst Daniel Yu, has quickly built a reputation for uncovering irregularities at the companies it targets.

Few institutional investors had heard of it until it published a strongly worded report questioning the accounts of Quindell, a UK-listed legal and insurance company. Quindell later won an uncontested libel action against Gotham but the impact of the report on its share price was devastating.

Having been one of the UK's best-performing shares over the previous year, helping Quindell grow to become one of the most valuable companies on the Aim market, the shares slumped as investors took fright at Gotham's assessment.

While Quindell denied there was any truth to the Gotham report, its founder and chairman Robert Terry later was forced to resign over misreporting a share transaction and Gotham was able claim an element of victory.

Some of the world's largest hedge funds profited from selling Quindell shares short, while bullish investors, including M&G, the investment arm of the Prudential insurance company, and the hedge fund Algebris, were left embarrassed.

Gotham followed up with an investigation into Gowex, a Spanish wireless internet provider that had grown into the largest company on Madrid's small company exchange. Less than a week after Gotham questioned Gowex's accounting, the latter's founder and executive chairman Jenaro Garcia admitted the company had fabricated its earnings and shares were suspended from trading.

Another group claiming success is Muddy Waters Research, run by Carson Block, which came to fame for alleging accounting fraud at a Canadian-listed Chinese forestry company that filed for bankruptcy protection in 2012.

Carson Block, founder of Muddy Waters Research, came to fame over an alleged forestry scam

Some critics argue, however, that such analysts can spread dangerous misinformation. "These guys can say anything they want and destroy the value of companies without facing any consequences," says one executive from a large hedge fund. "If one of my employees were to do what they do we would be called up by the financial regulator in five minutes."

Companies that have been targeted by short selling research groups have become more co-ordinated and robust in their responses. This year Noble Group, Asia's largest commodities trading house, issued a long and detailed rebuttal to allegations about its balance sheet by Iceberg Research, a group that publishes its notes on its blog and on Twitter.

But the vigilantes are unlikely to disappear soon. Company executives and investors may well just have to become accustomed to opinions from a broader range of sources than before.

And anyone contemplating committing financial fraud at a listed company must now be fearful in case the caped crusaders of the financial markets may swing in their direction.

Keeping the faith: protests against austerity reached something of a peak in 2013 (above) but overall Portugal has weathered the storm well — AFP

Lisbon maintains degree of balance

Profile Portugal

Unlike some peripheral eurozone countries, the crisis of confidence appears to have been well contained, reports *Peter Wise*

Angry groups of middle-aged, middle-class demonstrators have recently been swooping on individual bank branches in Portugal, occupying the premises, waving placards and shouting: "We want our money back!"

The protesters are victims of the collapse of Banco Espírito Santo, one of the country's biggest and most respected lenders until it unravelled last summer in one of Europe's largest financial failures. Individuals tell distressing stories of losing their life savings, being forced to close small businesses and struggling to support elderly relatives.

The protesters have accused account managers at BES of tricking them into buying commercial paper issued by disintegrating Espírito Santo group companies by leading them to believe they were putting their money into safe investments. Regulators, meanwhile, are wrangling over how to compensate more than 2,500 savers in this situation for losses in excess of €550m.

The demonstrations at branches of Novo Banco, the so-called "good bank" created from healthy assets salvaged from the ruins of BES, may seem to suggest a risk and asset management sector in crisis.

But overall Portugal has weathered the storm of its three-year international bailout and deep recession well. Despite the fall of BES, Portuguese investors have kept faith with their banks and their asset managers.

"Unlike in Greece, Spain or Ireland, confidence in Portuguese banks has never seriously been undermined," says Luís Saraiva Martins, a board member at Caixagest, the country's largest asset manager. "The crisis of confidence caused by the collapse of BES was limited to the bank itself and has not spread to other lenders."

As part of state-owned Caixa Geral de Depósitos, Portugal's largest banking group, Caixagest was a beneficiary of a huge outflow of funds from the BES group and Novo Banco. It argues, however, that it has resisted aggressively hunting for the business of worried savers.

"We deliberately held back and moved slowly," says Mr Saraiva Martins. "We wanted to capture new funds, but it was equally important to ensure that a degree of balance was maintained between the different players, especially in a country where the top five banks account for about 80 per cent of total bank deposits."

Domestic banks dominate asset management in Portugal. "The Portuguese typically channel their investments through banks by way of discretionary mandates," says Carlos Costa Andrade of the Lisbon office of Uría Menéndez, a Spanish law firm. "As a result, commercial banks are the market leaders and a large proportion of funds are allocated to discretionary mandates rather than directly invested in funds."

Caixagest is by far the biggest player with assets under management totalling €28.2bn at the end of 2014 and a market share in Portugal in mutual funds of 31.8 per cent, up from 24.1 per cent in 2007 and almost double the share of the next largest mutual fund manager, Banco BPI. At the other end of the scale are small banks such as Banco Carregosa,

'Portuguese households' confidence in the system has always been there'

which began private banking in 2009 with €10m under management and now manages a total of €200m.

"We expect to grow our assets under management at an average rate way above the market," says João Pereira Leite, head of investment at Carregosa. "We are growing from a lower base which makes it easier. If there are no major setbacks in the market, we hope to grow at an average rate of more than €100m on a yearly basis."

In the wake of the 2008 global crisis, asset management volumes and returns fell sharply from 2009 until a turnround in the first half of 2013, says Miguel Stokes of Uría Menéndez. "The upward trend is expected to be maintained in 2015 and 2016," he says.

In terms of investor options, money market funds have grown from about 24 per cent to more than 30 per cent of the mutual fund market between 2007 and the end of 2014. Balanced funds rose from 22.3 per cent to 30 per cent.

Direct investment in funds, as opposed to discretionary mandates given to banks, has been increasing since 2014, says Mr Costa Andrade. "In parallel, discretionary managers are searching for higher yield instruments," he says. "As in the rest of the eurozone, higher-yield investments, in both debt and equity, are expected to increase under the quantitative easing policy announced by the European Central Bank in February."

Mr Pereira Leite adds: "The traditional trust placed in banking systems across the world has been hugely damaged in recent years."

But in Portugal, unlike in some crisis-hit peripheral eurozone countries, "the confidence of households in the financial system has always been there", says Sofia Torres of Caixagest. "There has been no flight of deposits abroad."

In today's difficult low-growth, low-interest rate environment, she adds, this trust represents a chance for the risk and asset management sector "to show what it can do".

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