

# Financial Control Limited

## THE INVESTOR

June 2002

### Thought of the Month – Is the PRC ready for hedge funds?

Hedge funds and their managers now span most areas of the globe but what about the booming economy of the PRC? Is it ready for the “super-capitalistic” strategies employed by hedge funds? Or perhaps the right question to ask is, can hedge funds make money in the PRC? In other words, whether the PRC is ready or not, if attractive returns can be earned for a given level of risk, and exit strategies can be employed, hedge funds will come to the PRC whether it is ready for them or not! Robert recently visited Shanghai together with a group from the American Chamber of Commerce in Hong Kong and met with representatives from the investment banking and primary market, secondary trading and sales, real estate, manufacturing, accounting and legal professions and it was quite obvious the economy is booming based on the stories we heard and probably most importantly, based on the amazing buzz to the night life in that city. But unfortunately, the black market seems to offer the only reasonable alternative to repatriating profits that a hedge fund might earn. Despite reassurances that it is not a problem to repatriate royalties, retained earnings (via dividends), and other fees, Robert came back with the feeling that almost any foreign firm that is making money at the moment is simply reinvesting profits back into the PRC and except for some insignificant repatriation of profits via the above means, there were no practical examples of significant profit repatriation. Furthermore, for those firms that repatriate such insignificant profits, it appears that approvals from officials (district, city, provincial, etc.) are necessary. The goal at the moment is to try to repatriate small amounts instead of waiting for significant profits to accumulate only to find out that approvals might not be granted. In short, once a hedge fund determines a successful profit repatriation strategy, there is a dearth of instruments that can be traded as part of a typical hedge fund strategy: shorting is not allowed and there are no listed derivative instruments. On the other hand, hedge funds are known for their creativeness and aggressiveness, so it would not be surprising to hear about hedge fund forays into the PRC in the near future.

### Why is the Sky Blue? –Why is it so difficult for corporate treasurers to earn extra yield?

Of the classic challenges faced by corporate treasurers, earning extra yield might come second to getting board approval for derivatives trading outside of the usual currency forward and option positions. In other words, investment banks commonly pitch financial instruments to corporate treasurers that are designed to enhance yield. Often times such instruments are cash instruments with embedded options that pay-off under certain circumstances, such as when interest rates or equity prices rise or fall to a certain level. But the corporate treasurer normally faces two choices: try to explain such instruments to the board and get their approval or simply trade such instruments and hope that the board never realizes that such instruments contain optionality. Based on experience, corporate treasurers typically follow the former course but only for those instruments that they feel they can explain to the board and that have a chance of getting board approval. In other words, the battle to earn extra yield often has more to do with the level of difficulty in getting board approval rather than finding an instrument that matches a treasurer’s yield enhancement goals!

## Nourishment – How Risky are Derivative Products?

We often read in the press that a particular bank, hedge fund or company has suffered major losses and occasionally news of a collapse because of derivatives trading, but are these facts accurate and should one put all the blame on the products? From recent cases which include AllFirst Bank, Enron, LTCM, Barings, etc., one might conclude that the larger institutions are more prone to a disaster perhaps because they take on higher risks. Such episodes can easily convince the reader that derivatives are very dangerous products and could even discourage some institutions from using them all together. Let's explore these issues further.

Firstly, one distinctive feature of a derivative from a cash product is that in most cases no up-front payment is required which makes them seem cheaper and easier to trade because less capital is tied up. This could be very tempting for some traders to over-trade as their views of the markets change, yet this may not always increase the overall risk if the trades are offsetting. The fact is that on a single derivative trade, the market risk is equal to an equivalent cash product while credit risk is much less because there is no initial outlay of capital as with a loan.

Secondly, an attractive feature of a derivative is that it can be customized and structured in virtually an infinite number of ways, although the majority of trades are still based on generic or standard structures. This is very appealing to both traders and clients because it expands the opportunities for doing more business while servicing the clients more efficiently, but it may not always be so appealing to senior management and risk managers. In a well structured / managed organization, all derivatives used on the desk should be thoroughly understood and approved prior to any trading, and with the more complex products, approvals could take much longer than what traders expect. Approvals would generally come from an executive committee who rely on the expertise of the risk manager to understand the details of each derivative, examine the underlying risk(s) and make appropriate recommendations. But if the risk manager's skills are weak, the process will remain slow and potentially detrimental to the institution. It is not uncommon to see traders executing deals that risk managers don't fully understand or thinking that risk systems will take care of all the problems. At the other extreme, some traders are prohibited from using derivatives, which prevents them from adequately hedging their risks. Until such time that senior management and risk managers get a good grasp of the business, upgrade their skills, or seek professional help, there is always a danger that things could go wrong whether or not derivatives are traded.

This argument is not limited to derivatives trading. Until recently many individuals had little difficulty with on-balance-sheet products because of their simplistic nature and because few regulatory requirements were imposed. But with the introduction of the latest Basle accord and FAS133, things have to change fast at some institutions as one of the requirements is to mark-to-market the banking book and determine the level of interest rate risk. Some may find this too demanding but once the risk analysis is completed, they may find that the amount of exposure on their banking book is much bigger than they had anticipated and dwarfs the risk of any derivatives trading book.

Another issue that often comes up is how to book a new deal into a system. Some systems may already be weak in booking even generic deals, and handling the more complicated or customized deals could take a lot of creative thinking. If this is left in the hands of the back office staff who may not be as technically qualified as the traders or risk managers, there is always a risk that a trade gets booked incorrectly. Unless an error is caught right away, it could have drastic repercussions on both hedging and risk management, in addition to PNL errors.

Front office staff should not assume that once a trade is done their job is finished – actually it has only just started. Apart from managing the trade, they should ensure that each trade is booked correctly and reflects all the specifications set out in the documentation.

This leads me to the issue of documentation, which can sometimes be a nightmare. Many legal battles have been fought because of what is written may not mean the same to both parties when it comes to execution. We had cases dealing with settlement or exposure netting in the past, where a payment was disputed because certain clauses were misinterpreted, and lately a case between Nomura and CSFB over a credit default swap. With new structures come new problems and until the documentation is standardized there will always be new disputes over the wording.

We certainly can't cover all the possible scenarios where things could go wrong in this short space. The issues discussed above illustrate the fact that the biggest risk facing an institution may not be with the derivatives themselves but how well they are understood, used or abused, monitored and managed. An institution can have all sorts of policies and limits in place, and several systems to do all the number crunching, but these are never sufficient to overcome the various operational risks. A better understanding of derivatives may reveal that they are not as risky as one imagines and can actually enhance the performance of a desk or institution.

We would like to hear from you about your own particular experiences and difficulties regarding derivatives and perhaps let us offer our assistance in helping you implement practical solutions.

### [Feedback](#)

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com) if you would like a) for us to clarify something, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services! Or visit our site at [www.financialcontrollimited.com](http://www.financialcontrollimited.com)

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These newsletters are designed to provoke thought and stimulate debate based on real world challenges that we face in our daily lives as we manage investments for ourselves and for others.