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Sixth Issue



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February 12, 2009

Letter of the Editor

Dear Financial Executive,

Herewith, you receive the **Sixth IAFEI Quarterly**, which is the electronic professional journal of IAFEI, the International Association of Financial Executives Institutes. This journal is the internal information tool of our association, destined to reach the desk of each financial executive, who is a member of a national IAFEI member institute.

In this issue again, several IAFEI member institutes have contributed with own articles. We repeat, that we would like to see all IAFEI member institutes contribute with articles to this professional journal. Any time, we are open to receiving such articles for inclusion into this quarterly journal. We are not eager on numbers of pages. We are eager on content only

The FEI of the USA, last October 2008, has decided, to include our fifth IAFEI Quarterly as a section into their own electronic professional journal which they are sending to their American financial executives members. IAFEI is very much welcoming this move, which shows, that FEI USA and IAFEI are maintaining a good relationship and do now exchange professional views and articles. This fits well into the globalized world and its needs for information and cooperation.

The **39th IAFEI World Congress** was held in Paris, France, on December 14-17, 2008, and it was the year's highlight of professional information and networking for all the financial executives from around the world who were able to attend. We do thank the **DFCG, the French IAFEI member institute**, here again for holding this very successful IAFEI World Congress.

Last December 2008, the annual IAFEI Board of Directors Meeting was held in Paris, France. At this Board Meeting the **new leadership team of IAFEI** was elected. **See section IAFEI News, Activities.** The new leadership team of IAFEI stands for an amalgamation of change as well as continuity.

The **financial crisis** in much of the world is accompanying us, by now, into the third calendar year. It has by now contributed to recessionary forces being strengthened at first, and later on, it has led to a real recession, starting very abruptly, intensely and steeply in the last months of 2008, in all continents of the world. For many, the abruptness and steepness of the recessionary fall of economic activities is unmatched in their lifetime history. This reflects on the day to day business of the financial executives worldwide, and this reflects, of course, also on the Sixth IAFEI Quarterly.

As financial executives we have to react to this financial crisis with caution, composure, and circumspection. **Stabilizing measures worldwide** are either on their way already, or in the making and close to announcement. This particularly relates to the USA, from where the world financial crisis has emanated, and where the

new political administration is already reacting forcefully and with stamina to the crisis situation.

2009, for IAFEI, is the starting phase for having and soliciting **institutional sponsors**. IAFEI is happy, and thankful, for having been able to solicit **Deutsche Bank** as its first institutional sponsor.

With best personal regards

Helmut Schnabel

Institutional Sponsor of IAFEI, the International Association of Financial Executives Institutes:

Deutsche Bank



Sponsor of IAFEI,
starting 2009

It is the sponsorship policy of IAFEI, to thereby enhance the value of the organization to its member institutes and its individual financial executives members, around the world, while, at the same time, entering into a professional dialogue, by various ways and means, with the sponsoring corporations. In so doing, IAFEI is striving for having such corporations as sponsors, which are world class corporations, and among the best in their business sector, and with a truly global scope and focus of activities. Thus, IAFEI and its sponsors, want to jointly serve financial executives, worldwide, for their professional benefit.

Changes in the TMS Market – A Broader Range of Products

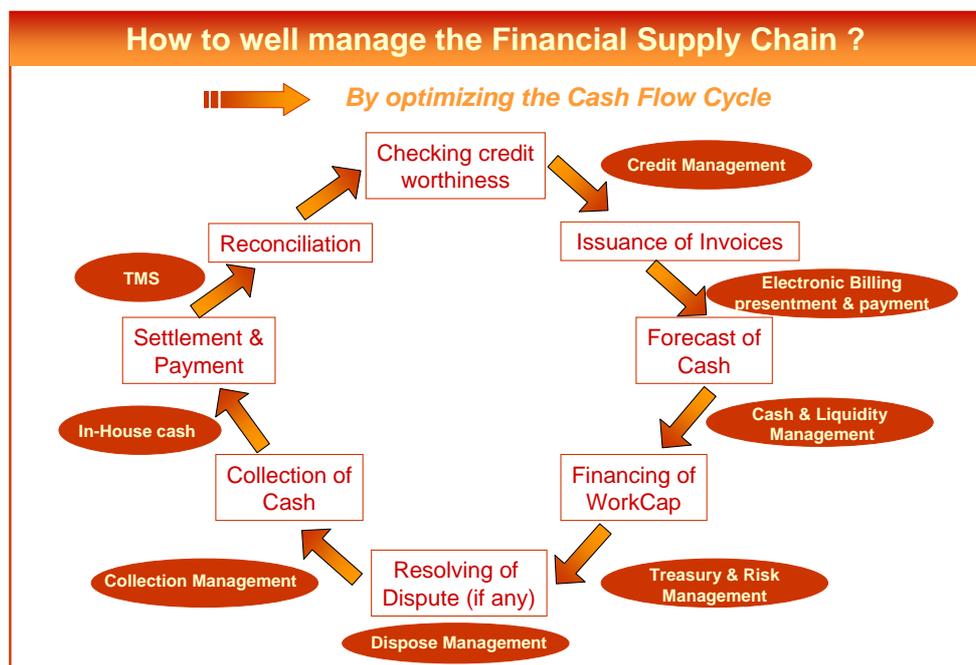
Author: François Masquelier,
Honorary Chairman EACT (European Association of Corporate Treasurers)

Over the past few years, the Treasury Management System (TMS) market has changed significantly. Consolidation, combined with horizontal integration, has limited product availability. Now the battle has begun between ERP solutions and more specialized, integrated product packages. Here, we take a look at the forces at work in this market and what is at stake.

The Consolidation Trend on the TMS Market

A combination of impressive technological developments from suppliers and the ever increasing needs of treasurers have put more complete, higher-performance product lines on the market than ever before. What treasurers want is STP (“Straight Through Processing”), real-time management, communication protocol standardization, user-friendly solutions, automation of repetitive, low-value-added processes, and integrated systems.

Over the past few years, the market has been consolidating. For example, without according more importance to one solution than another, there was SunGard – AvantGard, which acquired Integra-T, GETPAID, Trax and even XRT Globe\$. Its competitor, Wallstreet, did the same with Trema (which itself had previously acquired Richmond). Is this the end of the merger trend? Certainly not. The purpose of these mergers is to strengthen the companies’ footholds in the market while consolidating the underlying technologies. Their objective is to integrate the treasury parts (TMS such as Quantum or XRT), with cash management (Integra-T, Globe\$), Accounts Payable (A/P, with Trax and XES) and Accounts Receivable (A/R, with Getpaid or Coveris), as well as with the means of communication offered by Trax, XES and e-TX.



The chain is complete, or almost entirely integrated. Anticipating the movement of future purchases, even someone with little imagination could guess that Wallstreet will try to make acquisitions to supplement its Trema F/Kit and Alterna/CMM package. Wouldn't DataLog be the perfect target for them? Perhaps... but we should not forget that some smaller companies prefer to remain independent, which they believe makes them more responsive and efficient and keeps them closer to the client. There are arguments to support both points of view.

Market Fragmentation

This market has remained fragmented, despite the consolidation described above. The smallest companies are active locally, such as Sage or Kyriba in France. Newcomers have arrived, such as City Financials. At the same time ERPs like Peoplesoft, Oracle and JDEdwards are strengthening their positions. Other related specialized products could also be targets, such as FXall or 360T, Reval or SuperDerivatives, Speranza Systems, and others. The required functionalities are increasingly complex and require significant efforts to meet client needs, such as IFRS 7 & IAS 39, risk management reports (e.g. KontrAG, Cadbury and Bouton), compliance with Sarbox, and coming soon, the future E-Sox, Workcap, and more specific cash flow forecasts, among others.

Clash

There seems to be a clash between two camps. On the one hand we have ERPs, with their heavy artillery and enormous fire power, and on the other hand we have the specialized packages, such as the two described previously. Both have their advantages and disadvantages. Our intention is not to favor one solution over another, but the market is clearly taking shape; the specialized products, at the head of their class, need to sharpen their swords to compete with the heavy machinery. How long a seller stays in business over the long term, as well as its reliability, and its broader, more integrated product line will be major factors in determining how successfully it can compete. The arrival of the corporate product line from Swift is a good indication of this. Everyone senses that they should make a move and that the future of the market is already taking shape. With its recent purchase of Trax, AvantGard now offers a solution that creates a link between ERP, TMS and the other modules with *ad hoc* securities and controls, while providing access to the Single Windows concept from SWIFT. For example, AvantGard offers Quantum, Liquidity Express (LEX), Dashboard, GTM, APS2, Netting, Cash Predictor, Account Compliance, Risk, GETPAID and Receivable/Order-to-Cash. Without promoting any particular supplier, we will say that this kind of product line is a clear indicator of the company's strong desire to broaden its offering.

Remaining Targets

Targets are becoming scarce after such widespread consolidation and lateral acquisitions. However, products such as Datalog or Alsyon could be prime targets for a company such as Wallstreet. In the field of reevaluation products, Reval or SuperDerivatives come to mind; as for exchange platforms, we think of FX All and 360T (which is already allied with Misys for CMS and ICD) or even Exidio. Other predators, such as SimCorp or Misys, could also be tempted by such an approach. Although the market seems to have been sucked dry, here and there we are still seeing new potential targets cropping up.

The Big Decision: ERP versus Specialized Products

It is easy to understand why a multinational group would make the strategic choice to select central ERP (Enterprise Resource Planning) and a horizontal, non-fragmented approach. However, it is also tempting to opt for specialized, “best of breed” technology, which is often better adapted. Do ERP solutions meet the needs of companies in a dynamic economic environment? The increasing number of available solutions, even when perfectly interfaced, comes at a price. ERP solutions often have a weak link, and sometimes the treasury component is very specific. The more a company operates in a mobile, changing environment, the more the ERP product shows its deficiencies. Whether a company chooses an ERP solution will depend on its group IT policy, whether it is pursuing a streamlining strategy, and the idea of capitalizing on a technology and a particular language, where technical human resources often fall short.

Key-factors of ERPs versus specialist solutions

ERP	Specialist Solutions
<ul style="list-style-type: none">• Highly controlled centrally by IT team• Efficiency for single business• Slow to implement changes• Investment in specialist knowledge & skills is variable• Inherent interface• Broad functionality• Tied to investment cycle	<ul style="list-style-type: none">• More end-user driven• Efficiency for complex business• Upgrade cycle < 1 year• Investment in specialist knowledge & skills is paramount• Less widely available resources• Domain focus• ROI based

It is easy to understand the dilemma and the internal battles between operational teams and IT personnel. The primary arguments asserted by the proponents of ERP is that specialized solution companies do not stay in business very long, and they have interfacing problems. For this reason, the creation of a mini-ERP could be an interesting strategic response.

Mini-ERPs

Specialized financial solution sellers have adopted a sales strategy of Financial Value Chain integration. By purchasing competitors and producers of related specialized solutions, they are reinforcing their product, limiting competition and offering a more integrated panel of products. In fact, they could be described as little ERPs, considering the broad, complete line of services they offer. With this approach, they have provided an answer to the two main arguments against them.

They integrate the complete financial chain, from one end to the other, while optimizing it. But what if a series of 100% ERP solutions came to dominate SAPs or other Oracle products? This offer is adaptable and is built gradually by module. At a time when financial departments are pushing for maximized performance, this is one of the levers to press. In a Sarbox world, the benefits of automation and internal controls are crucial.

Improving the order-to-cash cycle affords an opportunity to be more competitive, consistent and effective with respect to the frenetic competition. Productivity can be financial and increase operational productivity. It also improves risk management and increases visibility while cutting costs.

Financial Reporting

The same phenomenon has been observed in the financial reporting sector. The group Business Objects (BO) recently acquired Cartesis. The purchase of this corporate financial and management software publisher is indicative of the objective pursued by the main companies in this sector to supplement their products in other areas of the market, such as performance management platforms, financial reporting, consolidation, financial governance, risk management and regulatory compliance auditing. With this acquisition, BO, has demonstrated that, like Oracle, it wishes to create a complete, integrated set of Business Intelligence (BI) services. Just as we saw with the software for the treasury business, we are seeing the same type of consolidation of all the tools in the chain. The product line has been broadened to better meet client needs. With Hyperion, Siebel and the ERP Peoplesoft, Oracle paved the road to integration in the BI sector. Here again, it is easy to imagine that the trend will continue in the years to come, with other acquisitions allowing the “big fish” to further cushion their dominant positions.

Financial News Duopoly

The merger between Reuters and Thomson, which were numbers 2 and 3 worldwide, respectively, will give rise to a giant worldwide leader in financial news with a market share of 34% (as opposed to 33% for Bloomberg). What will be left for the others? Financial news is necessary to feed market data to the TMS, but the selection of news providers will be rather limited. It may be easier, but it is doubtful that this will have a positive impact on prices for the user. We could conceivably see a comprehensive, non-flexible offering of financial services, based on high, fixed rates, without a real possibility of negotiation.

Is there room in these markets for anything else but the global-scale “monsters”? In this case, this merger is another example of the consolidation that is affecting all sectors of finance IT in the general sense. This over-consolidation is cause for concern over the medium term. However, Rupert Murdoch among others, has not hidden his interest in Dow Jones (no. 7 worldwide), which would reestablish the competitive balance.

In some cases, consolidation may become necessary, or even helpful. The reinforcement of smaller entities can give them the size, network, contact, support and permanence that earn client trust. Size is weighed against service, power against flexibility, permanence against personalized follow-up, and even standardization against specialized adaptation. As with everything, consolidation up to a certain degree of choice is advisable. Beyond that point, consolidation can deprive users of their freedom and become limiting for them.

Conclusions

The treasury product market has entered into an extreme consolidation phase. This trend will have both positive and negative effects for users. Greater size is not the solution to every problem. But for those who fear the all-powerful ERP, is it not preferable? The alternative is not vast, but it has its advantages. Interfacing will remain the key to the successful integration of the financial service chain. Integration and STP are and will remain the nirvana sought by all treasurers who aim for absolute efficiency. Can they find happiness in this environment of market consolidation without alienating themselves from their waning number of suppliers? Let us hope that the improvements that have been promised us will not be counterproductive. The job has become more complex over the past few years and treasurers are hoping to see technology finally meet all its needs, regardless of how it happens, even if it means market consolidation.

François Masquelier
Honorary Chairman EACT

Aspects of / Observations on the Worldwide Financial Crisis

Presentation by Helmut Schnabel, Chairman of the Association Chief Financial Officers, Germany, on the occasion of such organization's annual membership meeting on November 21, 2008

Since July 2007, we are going through a worldwide financial crisis, which in the meantime lasts into the sixth quarter since then, and which, so it seems, has reached its maximum height in October 2008. The crisis has taken dimensions, which exceed the imagination and experience of all humans living today. We have to go back into the history books, the Black Friday in 1929, and the ensuing great depression lasting for many years, in order to find an event in the history of humanity which is half way comparable. And still, as we all know, the situation of these both big events is not comparable, thank god, in many material aspects, and it is not so, that we now have to expect the advent of the second great depression over the last rolling hundred years for sure. And in spite of this: journalists, media, in general, reinforce the panic since many months, in an irresponsible manor.

For each financial executive this financial crisis of the last six quarters does cause substantial additional work, and it is an additional burden to work on being somehow only half way informed, which losses and financial accidents are just about happening where, what the causes are, or could be, and what greater dangers could develop from this. For all of us, in terms of personal work capacity, this is a highly burdened time.

The financial crisis escalated in September 2008, when the U.S. American establishment, unexpectedly, did let go bankrupt the large bank Lehman Brothers, and when the U.S. American President was not able to get his own parliamentary majority to support his subsequent package of savings measures. All of this, has only much more and dramatically worsened the situation and further exacerbated the general panic. Obviously, those responsible in the USA, have totally underestimated the additional thrust of loss of confidence, which has resulted from both of these events. After this followed further collapses of banks and insurance companies in the USA and in European countries, and also in Germany, with the situation at Hypo Real Estate Bank. And the national governments and central banks saw themselves forced to step in with the most dramatic ever seen support measures for the markets and economies which had to be set up, partly within a few weeks only, and in some cases even within a few days.

Looking back at this, we have to say, and we have to acknowledge, that the governments and central banks have acted in a most difficult situation with courage, efficiently, and quickly, and with huge amounts beyond imagination, in order to stabilize the situation and to regain lost confidence. Also in Germany, the great coalition forming the federal government, has acted, contrary to my own expectations, very efficiently and very quickly. I am convinced, the governments and central banks all over the world deserve our utmost respect for this.

While the worst could be prevented from happening in the short term, however, a sustainable stabilisation of the worldwide financial situation does necessitate further measures, especially by way of regulations, in order that the world financial system

can be stabilized and be built step by step. At present, only aspects of stronger regulations, worldwide, are being put on the table and not yet clearly defined regulation reinforcements. And already, last week, leading bankers of the world are warning from a too strong reinforcement of regulations for the banking industry. Obviously the great devastated field from which the surviving bankers are just about to step out again, is still not yet devastated enough, so that those who caused the crisis, the bankers, do regard it that time has come for a significantly stronger regulation. So it is to be expected, that we still have to go for several months through a public dispute about more additional regulation.

Only two years ago, it was regarded as backwards minded, if one as institutional investor, was not invested in collateralized debt obligations. Only half a year ago, Kurt Viermetz could speak out at a professional conference organized by the German stock exchange before 150 professionals, that collateralized debt obligations are almost criminal instruments, the role of which should be reduced significantly, and nobody was opposing this statement. So times have changed.

At least there is agreement, by and large, about the following causes of the present worldwide financial crisis:

- The excessive growth of off-balance sheets special investment vehicles and conduits and their partly short term rolling refinancing.
- The utilization of this vehicle, also for the worldwide distribution of U.S. subprime mortgage loans.
- The too low equity financing of Anglo-Saxon banks, especially the extreme leverage at U.S. investment banks, as well as the new situation, that the U.S. investment banking model is now dead, and that the survivors have returned to the universal banking system, including the business of taking customer deposits into the bank.
- That Basel II was introduced too late, only in 2008 in Europe. An earlier introduction would have prevented many excesses. And that in the USA the Basel II will only be introduced in 2011.
- The excessive de-regulation, respectively the too lax regulation of the financial markets in the USA, but partially also the too weak regulation in European countries.
- At the end, the existence of a so called shadow banking system, especially in the Anglo-Saxon world, but not only there, existing of hedge funds, of off-balance sheet special investment vehicles, of the excessive loan making to this clientele by investment banks and other banks, and all of this, largely, respectively up to totally unregulated, and without transparency and reporting.
- And last, but not least, the incompetent role of the rating agencies at structured products and securitizations.

And finally the next danger threatening, is the credit default market, amounting to 47 billion U.S. \$, about which up to now, there exists no transparency, which takes place on unregulated trading platforms which are not having the status of an exchange, and which is not taking place at a regulated exchange, which steps between both trading parties, and which acts as central counterparty, and which thereby assumes the counterparty risk, in case that a trading partner collapses.

All these are time bombs which have got to get eliminated.

Urgently needed worldwide solutions are being made more difficult by the fact, that the U.S. constitution provides, during the present three months November to January, only a transitory government which cannot act vigorously. The old outgoing government entitled for action, is weak, and the new government which is just about to constitute itself is not allowed by the constitution to tackle the problems. This is a very difficult situation, which however can not be changed.

The US-American Federal Reserve Bank has recently published that according to information which is only accessible to it, of the 47 billion credit default swap market over 90 percent is in the books of 17 banks of the world. One of them was Lehman Brothers. This example shows why the fact of letting the large Lehman Brothers go bankrupt, had such huge effects on the financial markets, especially in the direction of destroying trust among the banks.

Against this background, it is reassuring, that finally by mid-October, all big countries in North America and Europe, also Germany, have declared that from now on, they will not allow a larger bank to go bankrupt, no matter what will happen. It is clear, that without this implicit state guarantee, the confidence and trust in the financial markets would not return anymore.

The present financial market crisis has brought it to our attention very distinctly, that a functioning payment system and a functioning provision of the economy with loans by way of privately organized banks not only is a prerequisite of the success of a modern economy, but that they are also a public good which must be maintained and protected.

For us human beings is holds true, that the institution "bank" stands for notions such as solidity, seriousness, safety, stability, an organization which can be trusted. This trust has been destroyed by many bankers in North America and Europe. Not only has in many cases the risk management not functioned, not only banking principles, which have been valid since centuries, have been thrown over board. For instance, that one does not finance long term assets excessively by short term financings, and in general, that certain leverage ratios are just not excessively exceeded.

The now upcoming more stringent measures for regulation will therefore have to be painful, but in view of the damage of confidence, which has been caused, there exist no alternatives to this.

Let me give you an example to this: Even in its April 2008 paper "Lessons to Be Learned from the Financial Market Turbulences" the Federal Association of German Private Banks has asked in this 70 pages paper that it ought to be possible in the future, as well, in the "originate to distribute"-business model, that a loan making bank can take such loans out of balance sheet by way of a hundred percent securitization, in order to set free potential for new loan making capacity. Even then I have already supposed, that this cannot continue in this way.

The incentives towards lax loan making, which are wide spread in Anglo-Saxon countries because of relatively mild regulation, but which also occurred in Europe, can only be contained effectively, when such a lax bank can not get rid of this

instrument by way of hundred percent securitization. The partial retention of such loans in the balance sheets maybe in the order of 10-20 percent, but it almost becomes ineffective, when it is being reduced to 5 percent. I think, it is good, that an increasing number of voices, as for instance Alan Greenspan, or the European Commissioner for Internal Markets Charly McCreevy are now requesting, that this retention should be a fixed condition in the future. Also the Federal Finance Minister of Germany, Mr. Steinbrück is requesting such a 20 percent retention. This is good and right. By contrast, the present French Presidency of the European Union Council is asking for retention of 5 percent only: This is not enough. Even at this simple subject there is already dispute between the regulators. This is bad.

I say it again, if the upcoming new necessary increased regulations do not install clear limits, then the fragility of the world financial system will not change in the future. Then, human nature will again and again enter into risks which cannot be handled.

A last example: in the middle of the 90ies the U.S. American Financial Accounting Standards Board issued the regulation F.A.S. 140 which on the one hand asked for more disclosure of balance sheet vehicles and which on the other hand, however, allowed to a bank to take assets out of its group balance sheet by way of the sale to a special investment vehicle provided that this one is having an equity of at least three percent related to balance sheet total. This is equivalent to a leverage of 33 times, and this is exactly the leverage, with which the hedge fund Long-Term Capital Management went bankrupt 10 years ago. The result of the regulation was that special investment vehicles where mushrooming in the USA.

At the end of 2001, ENRON went bankrupt, also because it had to take back into the group balance sheet off-balance sheet trusts, because they had violated this 3-percent rule. The F.A.S.B. was therefore tightening in January 2002, the 3-percent rule to a 10 percent rule, known as F.I.N. 46. Following that, the banks exercised so much pressure on the regulators, that the F.A.S.B. still in December 2003 issued the new regulation F.I.N.46R, which made the previously released regulation less onerous. In April 2008, finally, the F.A.S.B. was forbidding the off-balance sheet vehicles all together, so called qualified special purposes entities. Immediately such large protests of the banks arose, that the F.A.S.B., in July 2008, cancelled this regulation until November 15, 2009. Source: Bloomberg October 30, 2008.

With regard to this, an example about the orders of size: The Citigroup reported in its reporting to the S.E.C. in June 30, 2008, that it maintains 1.180 Billion \$ of off-balance sheet holdings, among which 828 Billion \$, so called qualified special purpose entities. These are a kind of trust, where it is assumed, that it is not under the control of its creditors.

It is nor surprising, that in this deregulatory U.S. American climate, the U.S. investment banks number 2 to 5, namely Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns had a leverage, at the end, of 30-32, and thus an excessive hedge fund leverage. Since long, they had already themselves become great hedge funds.

Goldman Sachs contrasted against that, somewhat, with a leverage of 25.

This is, however, still twice the leverage, which is requested according to famous 8 percent equity capital ratio for the banks. This one is only 12, 5.

Final remark: The cumulative depreciation of the banking and insurance industry, because of the financial market crisis, is amounting, by now, according to Bloomberg, to 967 billion \$, of which 2/3 USA, 30 percent Europe, 3 percent Asia. Against this stand equity-emergency-infusions, worldwide, by shareholders, governments, state-owned funds, of a total of 827 billion \$. The U.S. American Nobel price winner Mr. Stiglitz comments these numbers sarcastically with the words: "We have exported our toxic mortgage loans, without this, our American problems would be a lot greater than they are anyway already." With these comments to the financial market crisis I want to leave this subject.

Two weeks ago, the workshop "Treasury" of the Association of Chief Financial Officers Germany has met in Munich at the MAN Group. The participants agreed, that there is the danger, that the banks are capping their loan making vis a vis industry, or that they may even reduce it. There are industrial corporations, which pay commitment fees, since years, for committed bank lines or syndicated bank lines, and which are presently shying away from drawing down such loans, because they are afraid, that the banks might oppose the draw down. Here I say it as well: At this situation we have arrived by now. We have learnt by now, that associations of German industry are about to voice their comments about this situation to the Federal Government, and we are welcoming such intentions.

The 1997 Asian Crisis and 10th Anniversary Market Crashes Snapshot of three Decades of Monetary Policies, Bubbles and Busts

Part One (of two parts)

(Originally published on April 12, 2007, in the Philippine Star)

Author: Eduardo H. Yap

Ten-Year Market Crash Cycles

Over the last three decades, global stock markets experienced episodes of stock market crashes or dramatic sell offs in ten-year cycles. On “Black Monday” October 19, 1987, stock markets worldwide crashed in what is now called the 1987 Crash wherein the United States Dow Jones stock index (DJIA) suffered the second largest value decline in stock market history. Ten years later in early 1997, the Bangkok bourse plunged and brought the entire region down in what is called the 1997 Asian Financial Crisis. While the crisis was still playing out during the year, fresh market turmoil broke out in Asia and the US in October 1997. It was the 10th anniversary of the 1987 Crash. The latest 2007 global stock spasm came exactly on the 10th anniversary of the 1997 Crisis when the record setting Shanghai stock market in China plummeted 8.8 percent on February 27, 2007. This one-day fall was as large as the record 8.9 percent drop suffered by Shanghai in the 1997 Crisis. Within the same day, the contagion immediately spread worldwide like wild fire. Although the latest episode is noted for its severity and global reach, it hardly qualifies yet as a crash.

Liquidity, blood and bull

Monetary policy & markets – History has established the correlation between the stock market and monetary policy, particularly those of the US Federal Reserve Bank and Bank of Japan. The ebb and flow of liquidity impinged on interest rates, currency exchange rates, the expansion and contraction of the economy and with it the fate of capital markets. The chair of the Federal Reserve Bank is considered the 2nd most powerful person in the US. His decisions move markets and his words are closely watched. Forecasting the trend and inflection point of interest rates, when policy changes, is crucial. Now there is a new dragon on the block to watch - the People’s Bank of China. It has started to flex its newly acquired but immense power backed by the equivalent of US\$1.4 trillion liquidity in Chinese banks under its control,

Baron von Rothschild. Bull markets are born when deep gloom pervades and a bust occurs when there is extreme optimism. These extremes create boom and bust cycles. Baron von Rothschild, the legendary banker to royalty, famously said “buy when there is blood on the streets” on the notion that the situation, being so bad and with prices so down beaten, can only improve. Many fear though that buying while the market is plunging is like catching a falling knife.

Boom after blood. The longest running US economic expansion and stock bull run in the 1990s commenced after the US-led air offensive of the Gulf War started in January 1991. The latest US bull market started in March 2003, after Iraq was invaded. In both instances, the market saw victory a foregone conclusion and scooped stocks.

Bad months. On Monday, September 17, 2001 the Dow index plunged 684.81 points following the 9-11 attack. This was the largest index point drop in market history. The months from August to October are unusually cruel for the stock markets: the October 29, 1929 crash which led to the US Depression, October 1987, 1997 and 1998 crashes, among others. Many world shaking events also occurred during this period: start of World War 1, World War II in Europe, Russian Bolshevik revolution and the rise of Russian communism, the fall of the Ching imperial dynasty, China's last, and the birth of modern China; the August 2, 1990 invasion of Kuwait and 9-11 attack. While the period from November to March, on the other hand, have produced better stock returns called the "January effect".

The 1987 Crash

The 1987 crash is remarkable for its global breath, severity of the losses and effectiveness of coordinated monetary measures taken by the major economic powers to rescue the market from melting down. On Black Monday, October 19, 1987, the Dow Jones index plummeted 508 points or 22.6 percent. This was the 2nd largest value decline in stock market history after the one in 1914. Trading was chaotic with frequent halts and delays owing to great order imbalances and system glitches. As in 1997 and 2007, the 1987 crash started in Asia. The Hong Kong market plunged and caused a worldwide crash when Europe and the US followed. By the end of October, stock markets in Hong Kong had fallen 45.8 percent, Australia 41.8 percent, the United Kingdom 26.4 percent and Canada 22.5 percent. (Chart#1 – Global Stock Crash)

October 1987 Global Crash

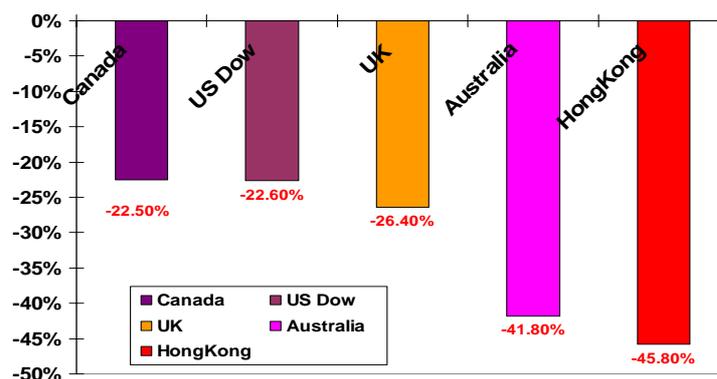


Chart #1 – 1987 Global Crash

Factors That Led To The 1987 Crash

Tight US policy, stratospheric rates and super dollar. In the 1980s the Reagan administration engaged the Soviets in an arms race that led to the breakup of the Soviet Union and the end of the Cold War. To finance the massive fiscal deficits incurred and combat inflation, the US Federal Reserve Bank under chair Paul Volcker, instituted a super tight monetary policy. Interest rates were pumped up and 30-year bond yield soared to over 15 percent in 1981. The world gobbled up US treasuries, in effect financing the spending spree. The US dollar appreciated mightily and attained near parity with the British pound sterling, the Japanese yen was depressed and other currencies dropped to record lows. Businesses suffered. US marques such as GM were seen as “dinosaurs” going extinct. Homebuyers fled homes and defaulted on mortgages driving many US savings banks to bankruptcy. The current account was deeply in the red and the economy in “stagflation”. Global stock markets were depressed.

Plaza Accord, policy reversal and 1st yen tsunami. On September 22, 1985, the then industrialized G-5 nations, agreed to reform monetary policy in what is called the Plaza Accord. The US Fed reversed its tight monetary regime, liquidity was injected and interest rates declined. Stock markets went on a bull run until it crashed in 1987. The US dollar depreciated rapidly and lost half its exchange value against the yen in just two years. Gold soared. Now it was the mighty yen. Values of Japanese stocks and properties soared. With a tsunami of yen, US businesses and assets were gobbled up, including trophy properties such as the Rockefeller Center in Manhattan and Pebble Beach Golf Course in California. To remain competitive, Japanese factories sprouted in Southeast Asia. Taiwan, also with a strengthened NT dollar, followed suit but focused mainly in emerging China. Chinese “special economic zones” boomed. The Hong Kong market was in a frenzy of initial public offerings (IPO). The Philippines, with the People Power Cory administration besieged with political instability, missed the boat.

Monetary policy dispute. A common belief attributes the 1987 crash to a dispute in monetary policy between the US and Europe. The US was seen tightening interest rates faster than the Europeans in an effort to prop up the Plaza-weakened dollar and tame inflation. The HK exchange rate to the dollar was threatened and market volatility increased, causing widespread nervousness. By October, investors fled the dollar-backed HK market until it plunged. Others blamed computer-driven program trading, which automatically triggered sales orders, as contributory to the massive collapse.

Recovery. After the explosive Black Monday “selling climax”, the stern German Bundesbank, announced it would not raise rates and massive liquidity was injected into the system on both continents. Measures were instituted to prevent program trading from running amuck. Thereafter, good economic fundamentals, robust corporate earnings reasserted amid an accommodative monetary policy environment, and the markets recovered ...until the next big one in 1997.

1997 Asian carnage revisited

Stock & currency bust. Ten years later, in 1997, Asia was again the epicenter of another stock market crash in what became the Asian Financial Crisis. It started when the fall in Thai stocks intensified in February. By March, the collapse was region-wide. Within 8 months, almost three-quarters of market valuation vaporized. The Thai baht peg

to the US dollar broke and it plummeted on July 2. The Philippine peso followed next within July and by August, it was the turn of the Malaysian ringgit and Indonesian rupiah. By year's end, the value of the baht and rupiah was cut by over half; with the ringgit and the Peso not far behind in losses. China recorded its worst one-day stock plunge and the renmenbi depreciated. Many believed investment guru George Soros had a hand in the regional currency blowout. Soros previously gained world fame for forcing the Bank of England to devalue the pound sterling and gained US\$1 billion. (Chart #2 – Asean 4 Market Collapse)

1997 ASEAN Equity Meltdown

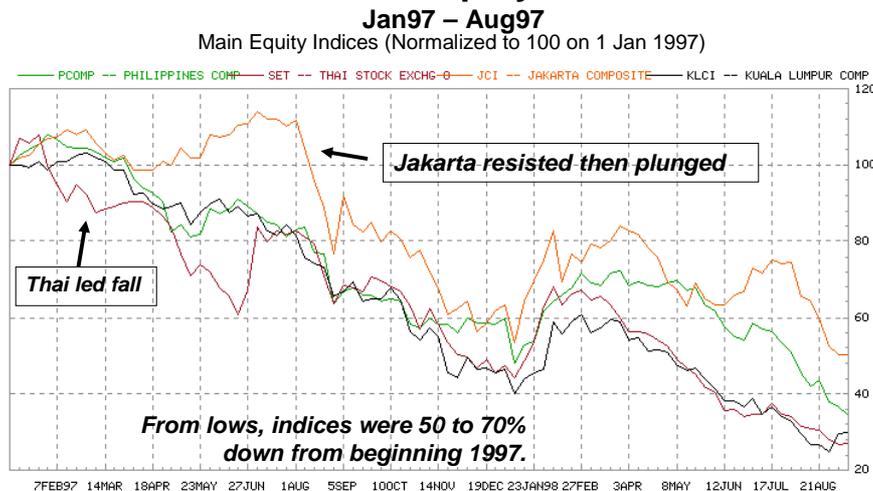


Chart #2 – Asean4 1997 Collapse

Recession and turmoil. Asset values deflated. Credit dried up. Inflation soared, highly leveraged businesses went bankrupt, weak banks closed and unemployment soared. Economies across the region were contaminated and went into recession. Indonesia suffered the most with economic growth falling from a positive 5 percent to negative 15 percent by the 2nd quarter of 1998. The Suharto government in Indonesia fell in May 1998. The Philippines, late to the party and with its fiscal position in fairly good order under the Ramos administration, sank just the same with the rest. The economy of South Korea imploded from its highly leveraged capacity expansion and fiercely patriotic Koreans lined up to turn-in gold and jewelry to help save their battered economy.

Rescue Measures. Malaysia imposed capital controls to stanch the hemorrhage. The HK Monetary Authority spent over US\$10 billion in defending the HK dollar against intense speculative attack aside from raising overnight interest rates to over 20 percent. At a critically low point in the stock market, the HK Monetary Authority bought HK\$120 billion of index component stocks to fight off short-sellers. The HK dollar peg to the dollar held and the stock market stabilized. But the “interventions” were harshly criticized by free market advocates. The International Monetary Fund (IMF) was severely censured for its emergency rescue measures, which were seen as late, ineffective and the conditionalities, with its one prescription-fitting-all solutions, as causing more damage. However, the 1997 economic meltdown, despite its severity, was confined to Asia.

(To be continued)

The 1997 Asian Crisis and 10th Anniversary Market Crashes Snapshot of three Decades of Monetary Policies, Bubbles and Busts

Part Two (of two parts)

(Originally published on April 13, 2007, in the Philippine Star)

Author: Eduardo H. Yap

Carry trade, the 1997 Asian crisis and Internet bubble

BOJ loose policy and 2nd yen tsunami. After the Japanese asset bubble burst in 1990, the Japanese economy spiraled down into a long-lasting and stubborn recession. The Bank of Japan (BOJ) instituted an extremely loose monetary regime that provided massive liquidity and practically zero interest rate to coax the economy to life and reverse deflation. Instead of investing in the moribund economy, capital was exported globally in search of better returns in a 2nd yen tsunami after the 1st one in the mid 1980s

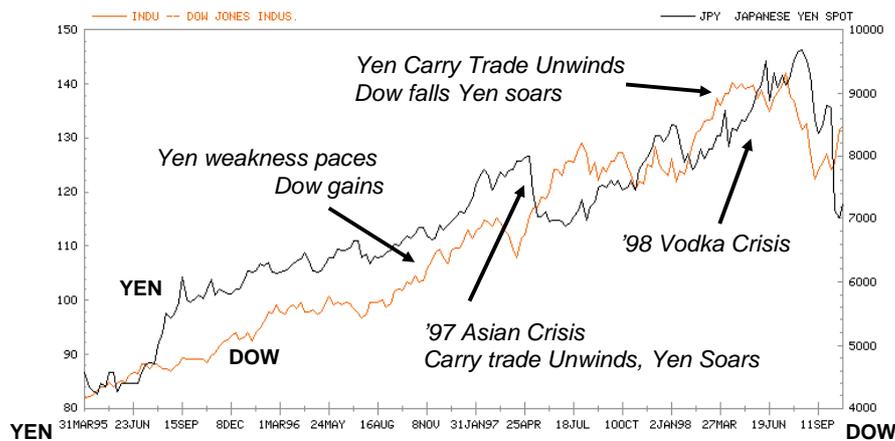
Failure of monetary policy. The monetary regime of fixed exchange rate coupled with high interest rate instituted by most Asian countries prior to the Crisis was easy prey to speculators, whose opportunistic forays were aided by the cross-border mobility of capital. After the 1997 crisis, the fixed exchange rate system was abandoned.

The trade. The yen and other low-cost currencies were borrowed massively and invested in higher yielding foreign currencies, debt instruments and assets. The yield differential gained is called a positive “carry” and such was given the name for the trades. In the mid-90s, the fixed exchange rate of Asian currencies eliminated the risk of loss from exchange rate fluctuation and this made the trades highly profitable. Additional gain was made when the borrowed yen depreciated, making loan repayment much cheaper. From the yen’s post-Plaza high of 85 to the dollar in May 1995, it dropped until a dollar fetched 115 yen by the end of 1996. Hedge funds joined the feast and highly leveraged their bets. Unfortunately, the flood of capital resulted in overblown capacity expansion and the excessive asset valuations were unsustainable. Fearing loss from currency devaluation, carry trades quickly unwound and investors stampeded en masse for the exits. Hot money flew out just as quickly as they came in and the Asian bubble burst in 1997.

US stock & Internet bubble. Following the end of the brief Gulf War in early 1991, the US experienced the longest economic expansion and stock market bull run that lasted 10 years. This prompted talk of a “new paradigm” or “Goldilocks” economy consisting of moderate growth, robust corporate earnings and low inflation. This stock bull run coincided with the loose monetary policy of the BOJ and the weakness of the yen that provided strong incentive for the yen-Dow carry trade. The US Dow index rose an astounding 388 percent from 2,442 points in October 1990 to a record intraday high 11,908 points in December 1999. The Internet mania brought the Nasdaq, the exchange where smaller companies and Internet start-ups were listed, from

329.80 points in October 1990 to a dizzying intraday high 5,132.52 points on March 2000 or an astronomical gain of 1,456 percent! Federal Reserve chair Alan Greenspan called the euphoria “irrational exuberance” and tightened monetary policy with a series of rate hikes. The Nasdaq crashed in March 2000 and lost 75 percent of its value to a low 1,305 points on March 3, 2003. (Chart #3, Yen : Dow carry trade)

Yen:Dow Carry Trade Mar95 – Sep98



Chart#3 - Yen:Dow Carry Trade

10th anniversary shock of 1997 crisis in 2007

Epicenter Asia. Again, 10 years later, global stock markets dropped on February 27, 2007. Asia was again ground zero with the high flying Shanghai stock index plunging almost 9 percent. Within the same day, Singapore dropped a severe 4.51 percent, Japan’s recovering Nikkei 225 plunged 3.56 percent and Kuala Lumpur by 3.99 percent. Surprisingly the Philippine market initially bucked the trend but the resistance was short lived.

Global breath. From Asia, the contagion spread westward to Europe. Milan dropped 3.20 percent, Paris and Frankfurt followed with a decline of 3 percent. The markets in the Americas were next. Right from the opening bell, the Dow Jones stock index plunged. At 2pm in New York, the Dow had a 200 point precipitous fall - one of the fastest drops in US stock history. It closed the day down 3.29 percent or 416 points, which was the worst one-day index point decline since the largest one after the 9-11 attack. Latin America was likewise not spared. Recently resurgent Argentina suffered the most with a 7.49 percent drop, followed by Brazil at 6.62 percent and Mexico at 5.80 percent. Over a trillion US dollars in wealth was wiped out.

Predicable flight to quality

As in all stock market turmoil, investors became averse to risky assets and fled stocks for the security of safe haven investments - US government securities and gold. The sudden demand caused the price of 10-year US treasuries to rise and, inversely, yield

dropped to 4.53 percent from the previous day's 4.63 percent. The price of gold rose US\$10.70 an ounce.

The 2nd 2007 Sell-off

After some calm and sense of relief was restored, particularly when the market perceived the carry trade was not being unwound, the 2nd downturn hit. Like all surprises, it came without warning like a thief in the night. This time, it was in the US. On March 13, reacting to bad economic news, the Dow slumped 242.7 points or 2 percent. Market jitters were reignited. The following day, markets in Asia and Europe followed in lockstep albeit to a lesser degree than the first wave in February.

2007 shock, the catalysts

Liquidity, BRIC & asset bubble. Prior to the latest drop, global markets were experiencing a bull run with record highs being set, fueled by a global financial system awash with liquidity, strong economic growth and corporate profits. The emerging BRIC economies of Brazil, Russia, India and China, led the boom. China had amassed a trillion dollar foreign exchange reserves, the largest in the world and the equivalent of \$1.4 trillion in liquidity sitting in banks. The mountain of petrodollars was being recycled. The Japanese yen carry trade continued and record low global interest rates drove investors in search of higher returns. The global markets were sitting on fat profits and analysts warned of overheating and overblown asset values.

US liquidity and housing bubble. Aside from the BOJ's infusion, additional liquidity was provided by the US. To stave off a recession after the Internet bubble burst in 2000 and the 9-11 attack, Fed chair Greenspan reversed tight monetary bias and embarked on a long-running series of stair-step quarter-point cuts. The Bush administration also helped with fiscal stimulus by way of tax cuts. As a result, the yield of 10-year treasury notes plunged to a 40-year record low 3.10 percent in June 2003. While 30-year bond yield dropped over 50 percent from 6.69 percent in January 2000 to a record low 4.17 percent in June 9, 2003. Global interest rates and US mortgage rates followed south. The housing sector decoupled from the soft broader economy and a housing bubble was created. After the March 2003 invasion of Iraq, the US economy recovered and the devastated post-Internet bubble stock market recovered and went into a new bull run. (Chart #4, US mortgage rates & bubble)

Drastic Decline in US Mortgage Rates, 1990-2003 Creates Housing Bubble

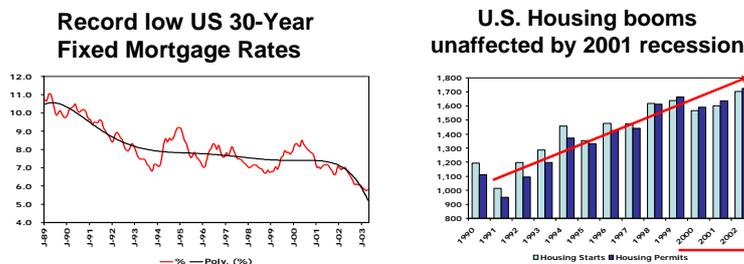


Chart #4 – US mortgage rates & bubble

China tightened. The People’s Bank of China started tightening measures in January, raising interest rates and bank reserve requirements. Fears of new fiscal measures from the annual People’s Congress added to market jitters until Shanghai made the market rattling one-day plunge on February 27.

US housing woes. When it rains it pours. Coincidentally, the US government reported a large drop in January durable goods orders that was seen as sign of a cooling economy. This chilling report reinforced the large same day US sympathy sell-off in the US, which was compounded by fears of the carry trade unwinding. The 2nd drop in March 13 came when the market was jarred by reports of new trouble in the already beleaguered US housing market. Lenders reported 4-year record high delinquencies in sub-prime mortgages and foreclosures. The specter of a hard landing in the important housing sector loom large and contagion to the larger financial sector and broader economy is feared. Former Fed chair Greenspan’s ill-timed warning of a possible recession further shook the market. The “Goldilocks” US economy was seen in danger. Again, aversion to risky assets rose and investors ran for the exits.

1997 and 2007 - Similarities and contrast

Similarities. Is history repeating? Arguably, there are some similarities. The asset speculative fever was driven, now as it was in the 1990s, by excess liquidity and the yen carry trade amid good times. Investor confidence, in both cases, was very high. Another similarity is the favorite borrowing currency for the carry trade, which remains the low-cost Japanese yen reinforced by other low-cost currencies such as the Swiss franc. The global financial market was seen like a casino. A decade hence, it remains a casino.

Differences. Yet, there are significant contrasts in conditions between 1997 and 2007. In the 1990s, Asian currencies were artificially pegged to the US dollar. This allowed the carry trade to flourish without exchange risk. After the 1997 Asian bust, monetary authorities learned their lesson and allowed their currencies to float more

freely with market forces largely setting the rate. Unlike before, there is no exchange distortion explosive enough or profitable enough for somebody like George Soros to exploit. The current boom is well supported by high economic growth in the BRIC economies.

Other Financial Crises

Tequila & Vodka crises. In between these 3 crashes, there were others. Notable among them were the Mexican “Tequila” debt crisis in 1994, where President Bill Clinton exercised executive authority to provide an emergency financial lifeline after much resistance from the US Congress; and the Russian “Vodka” ruble debt default crisis in 1998. In both cases, it was excessive debt burden that could not be sustained by their economy.

LTCM bust & rescue. A notable offshoot of the Vodka debt crisis was the bust of a largely unnoticed US hedge fund, Long Term Capital Management (LTCM). Enormous highly leveraged investments were made using sophisticated proprietary computerized trading systems to exploit pricing inefficiencies on a wide range of financial instruments. But as the crisis hit, the fund was deluged with investors’ demand for redemption. Investments were liquidated to raise cash for the redemptions. The sales, amid the spooked market, fed the rapid and sharp down-spiral in values of securities and stocks. This affected the balance sheets of large mainstream financial institutions, whose massive investment holdings were threatened with huge losses. Seeing the stability of the financial system at risk, Fed chair Greenspan intervened with the help of global financial giants who injected billions of new capital. Redemptions were met with the freshly infused capital and the selling subsided. Stability was restored and the markets recovered. The rescuers, aside from saving themselves, reaped profits.

\$64 Question – Is the party over?

US headwinds. Some analysts like Marc Faber of the Gloom, Doom and Boom Report, who called the 1987 crash and also saw a correction coming last January, consider current valuations overstretched amid declining global growth. Strong headwinds are facing the US economy and former Fed chair Greenspan warned of a possible recession. This is bolstered by danger of a hard landing in the important housing sector and indicators pointing to a contraction in the US manufacturing sector, while consumers are topped out. The US bull market, already on its fourth year, is considered in its mature stage and at a crucial turning point. Recently, new Fed chair Ben Bernanke chided the market for ignoring stubbornly high core inflation and with that the prospect of a market-lifting Fed cut by June had faded. The US market is now tugged in opposing directions depending on economic news being announced.

Global factors. Geopolitical risk is high with Iran’s nuclear ambition that has seen oil prices soaring again. The People’s Bank of China has started mopping up excess liquidity with monetary tightening measures. Interest rate and bank reserve requirements were raised thrice so far by April in 2007. These could crimp the markets.

Positive factors. Still, other analysts see stocks undervalued relative to bonds because of their very low yields. The recent spate of corporate mega-mergers and stock buy-backs are seen as market supportive. Robust BRIC economies plus respectable growth in Europe and some signs of spring in Japan are providing additional support that would underpin asset valuations. While before, a lone US super economic engine was

firing, now the global economy is firing on multiple engines of growth. Funds have recently flowed back to emerging markets unmindful of the recent swoon.

Can China decouple from the US?

It is said that the world catches a cold when the US sneezes. Can domestic consumption-led growth accelerate fast enough in the BRIC economies and be less export reliant on the US? This particularly applies to China with its great wall of foreign exchange reserves and, as with India, a gargantuan domestic market still with vast potential. Shanghai has, by the end of March, recovered all lost ground and set new market highs while the US is struggling to recover. Is the market telling us that China can avert contagion from a US downturn? Nobody, without the benefit of hindsight, can say so for sure. But history tells us a bust follows speculative binges whether it is a tulip mania, Internet bubble or other asset bubbles. A soft landing is difficult to achieve. It is more a question of when and the degree of severity of the fall. Or perhaps China has learned enough from Japan's painful experience to avert a similar asset bust disaster.

Eduardo H. Yap

*(The author, a certified public accountant, is a property developer and former chairman and president of the Subdivision and Housing Developers Association (SHDA). He presented an analysis of the 1997 Asian Financial Crisis at a forum by the Human Development Network on November 4, 1998; published "A Tax-less Economic Growth" on October 22, 2004, an analysis of the principal cause of the drastic decline in fiscal revenues that was cited by the Asian Development Bank in its 2004 Philippine Yearend Economic Review and "Is the Economy Overtaxed" on December 1, 2004; featured in "Financial Analyst Proposes Novel Fiscal Measures" on September 30, 2005, in **The Philippine STAR**.)*

News: Time Has Come For The Regulators Arising Consensus For Uniform Global Supervision of *Hedge Funds*

February 5, 2009. Chances are good for the creation of a globally recognized global code of conduct for the hedge fund industry. This, at least is expecting the Federal Association of German private banks. According to this banking association, it is necessary, for the purpose of control of the systemic risks emanating from the hedge fund industry to improve regulations for this investor group. For the German Financial Supervisory Agency for this reason, time has now come for the regulators. The German Federation of the alternative investment industry holds against that by saying that one should not forget, that in many European countries already do exist legal regulations of hedge funds. Nevertheless, also this association is pushing for a worldwide solution which embodies as well already existing numerous initiatives for a better regulation of hedge funds. The European Union Commission, as well as the International Organization of Securities Commissions (IOSCO) worked intensely on respective proposals. In the IOSCO, the regulators of the security exchanges as well as of the futures exchanges already do work together. In the USA, the President's working group has already worked out voluntary industry standards, which in the future become part of legal regulation.

Especially after the Madoff scandal, even the hedge fund industry has recently shown readiness, to accept a better regulation. The hedge funds, in future, already wish to disclose in a clearer way, their own conduct of business. After Madoff it is not a surprise, that hedge funds will be required to show real transparency to their investors.

On the other hand, representatives of the financial services industry are already warning, to overdo things for the purpose of regulation itself. It should be noted, they say, that the hedge funds were not the causes of the crisis, say the experts at the Federal Association of German private banks. The request by the G20 group for tougher regulations and for a supervision of all market participants does include the regulations of hedge funds as well. What is necessary, is an internationally uniform supervision of market participants which have a significant influence on the global financial markets and which therefore could represent a systemic risk. Starting point must be the supervision of all investment collecting corporations which so far have not been supervised and regulated. These players are to a large extent domiciled in the tax heaven territories of the world. It is to be expected, that such investment scheme providers will find it hard in the future to find investors, if they not recognize in a binding way industry standards and if not, in addition to that they are under an adequate regulatory supervision.

*Quoted from Handelsblatt, February 5, 2009
Translated by Helmut Schnabel*

News: Dispute on Derivates Is Exacerbating U.S. Politicians Are Drafting Legislation Meant to Forbid Speculation

January 30, 2009. The discussion about tradable credit default insurances is entering into new dimensions. According to Mr. Peterson, member of the U.S. House of Representatives, he wants to dry up the credit default swap market which is estimated to have a volume of 30 Billion \$. A respective draft of legislation is said to be in the making.

Peterson wants to allow for trading with so called credit default swaps, CDS, only for such investors, which are also invested in the underlying bonds. According to estimates of Eric Dinallo, the Head of the New Yorker Insurance Industry Supervision, over 80 % of all CDS are traded by investors, who are not owning the underlying bonds. Hearings about the drafted legislation will take place next week.

Institutional investors can hedge their bond and credit portfolios, by way of paying premiums, for which they get a compensation for any damage, if the debtor defaults. However, in the meantime, most investors in CDS are doing this only for the purpose of speculation. They are owning only the CDS, they are betting for instance, that the credit worthiness of a debtor is decreasing, and that insurance, respectively CDS premium is increasing. The protection, which they own, they can then sell to other investors at increased prices. In so doing they also earn money when bond prices are falling.

Since the worsening of the financial crisis, politicians and supervisory agencies, worldwide are pressurising, to regulate the trades with CDS. Their argument: The bankruptcy of Lehman Brothers, as well as the almost bankruptcy of the U.S. insurer AIG have shown, that significant risks are spreading from the CDS market, for the stability of the financial markets. Both corporations were heavily active in the CDS market. Dinallo, Head of the New Yorker Insurance Industry Supervisory Agency, had already tried in September, to install tougher regulations in New York regarding the trade with CDS, which are being traded without the underlying bonds, but later on he retreated from the effort.

Experts are doubting that the draft legislation of Peterson will pass through parliament. The proposed restrictions are so drastic, that there are doubts, weather they are a real option for action. The European Union Commissioner for internal markets, Mr. Charlie McCreevy, was underlining in an interview with Bloomberg at the World Economy Forum in Davos, that he is against a ban on trade with credit default swaps. Observers are also concluding that the threat with restrictions seems to serve the purpose, to restrict the banks sufficiently so that they cannot oppose other reforms regarding the CDS market. At the core of the reform proposals, so far, is the suggestion, that investors should not be allowed to trade directly among each other such derivatives. Rather, clearing houses should step in between, which take over the risk. Such clearing houses, for this role, will collect fees, and they will request from the investors so many securities, that they themselves will be sufficiently capitalized in order to meet their obligations.

This would reduce the risk that in the case that an offerer of CDS goes bankrupt, the credit default insurances would be worthless. The insolvency of Lehman Brothers, for this reason, has caused heavy turbulences for the financial markets. As well the draft legislation of Mr. Peterson, as well as the European Union Commissioner of internal markets Charlie McCreevy are pressurising, that investors should utilize central clearing houses. Many

exchanges are working on respective concepts. The Liffe exchange in London is offering such clearing since November. However, this offer has been hardly utilized so far.

Quoted from Handelsblatt 30./31.01/01.02.2009
Translated by Helmut Schnabel

News: Banks Should Improve Their Stress Tests Basel Committee Issues Consultation Paper

January 7, 2009. Banks should improve their stress tests, as a reaction to the financial market crisis, because there have been great failures in this field. This states the Basel Committee for banking supervision in a consultation paper. The institutes should not underestimate the depth and duration of crises. In addition the effects on an entire bank group must be analysed, instead of only testing the risks for individual divisions.

With this consultation paper, the committee is reacting to a request of the world financial summit which the group of the 20 most important industrial and emerging countries (G20) had held in Washington in mid-November 2008. Comments to this paper can be filed to the Committee until March 31, 2009.

In former stress tests, in which banks had to analyse the effects of heavy but imaginable crises, it is said, that often only scenarios have been analysed in which the banks had maximum losses in the amount of one quarterly profit. The history has shown, however, that banks can loose a lot more in difficult situations, is stating the Committee. In addition to that, it is said, that banks had already themselves too strongly relied on statistical data of the past, although experience has shown, that such data are not always good indicators for the future. As an example, the correlations of different capital market instruments can change heavily. The longer stable positive capital market phases are lasting, the more optimistic the risks are being evaluated, as the data from the recent past are then very positive. A decisive reason for the present crisis is also said to be, that the banks had not sufficiently tested the risks of new, complex products like securitizations, underlines the Committee – which to some extent has also been due to a lack of historic data.

Many banks are said to have made stress tests only in an isolated fashion for individual divisions, certain risks and portfolios. It is further said, that not sufficiently has been tested how crises like the present one would have impacted the results of the entire bank. Whereas banks are testing since long market and interest rate risks, it is said, that only recently they had begun to stress test credit default risks.

Banks are requested, to not only review the content of their stress tests, but that they also put down in writing the procedures, is requesting the Committee. The supervisory agencies should stronger observe such tests. Such supervisory agencies could also develop additional stress tests for banks of their own, proposes the Committee.

*Quoted from Börsenzeitung, January 7, 2009
Translated by Helmut Schnabel*

News: IASB Re-Regulates Consolidation of Special Purpose Vehicles **Guest Commentary by KPMG Europe LLP**

December 20, 2008. After intense political discussions about the causes and effects of the financial crisis and the concomitant role of accounting standards, the international standard setter IASB has published the draft standard "ED 10 Consolidated Financial Statements".

The IASB has seen itself under increased pressure for action, due to several causes: "The report on enhancing market and institutional resilience" of the Financial Stability Forum, in April 2008, which contains requests for the quick improvement of regulations of accounting and disclosure as regards non-consolidated special purpose companies.

Also, the heads of governments and states of the 20 leading industrial and emerging market countries (G20), which had convened in November 2008, at an extraordinary summit on issues of the financial markets and the world economy, had requested in their final statement, that the standard setters should quickly improve the standards for accounting, disclosure and transparency of not consolidated special purpose companies, already in the near term.

The draft of a new standard is introducing a new concept of control. Also, under the new proposals it is decisive for consolidation of another corporation that there is the possibility, to control the other corporation. Control, under ED 10, is existing, if a corporation, producing financial statements, is able to determine the activities of another corporation, in order to generate cash flows into the controlling operation. This concept is being applied uniformly for all potentially controlled corporations, that is also for special purpose companies, which are called "structured corporations".

Apart from the possibility, that control can exist by way of the majority of voting rights in the respective boards of the other corporation, the draft of a standard also formulates for the first time the possibility, that control can also exist without majority of voting rights, but instead based on the effective situation. Such an effective control can, for instance, exist, in a case, when the leading corporation has more voting rights than all other parties that have a relationship with the corporation, and when such other voting rights are widely spread and are not being organized among them (for instance, in order to exercise such voting rights jointly). With this, for instance, in the future, voting majorities present on annual stock holders meetings can also exist without the absolute majority of voting rights and can therefore establish control.

In addition to that, and according to the draft proposal of IASB, when analysing the possibilities of control, one also has to take into account economic dependencies of one corporation from another (for instance by way of important client relationships of the other corporation).

Special attention has been set by IASB to the so called structured corporations / with special purpose. According to ED 10 a corporation is a structured corporation, when it's activities are reviewed to such an extent, that the influence over strategic finance and business policy can not be realized under the principles, as they apply for corporations, which are steered by way of exercising voting rights in the relevant board.

The balance sheet producing corporation, in evaluating control over a structured corporation, must analyse a number of individual factors, for instance the break down of cash flows from the structured corporation between the participating parties and the kind of decision making process, which decides about the restricted activities of the structured corporation and which

thereby influences such cash flow. The IASB is requesting with ED 10, compared with the requests according to IAS 27, a large number of new information for the notes to IFRS financial statements. The essential requests comprise, first of all, a description of the basis of the control over another corporation and of the related decision fields of the balance sheet producing corporation. In addition to that, information requests are proposed regarding the influence of not controlling partners and about restrictions regarding consolidated assets and liabilities.

The most important new proposal for reporting, according to ED 10 are the new requirements to extensively describe the relationship to the non-consolidated structured corporations. This relates to the nature and to the extent of the relations to non-consolidated structured corporations as well as to the nature, the extent and the changes of the concomitant risks. In making this general requirement, ED 10 contains an extensive catalogue of individual reporting duties.

With ED 10, IASB has presented a new draft for a standard, which over the next weeks and months will not only be discussed among balance sheets experts. The corporations which are producing financial statements according to IFRS should intensely participate in this discussion and they should utilize the possibility, to present their own positions in a comment letter to the IASB. After a first evaluation of the draft it is still too early to make a general statement, as to whether the new proposals will lead to a significant extension of the number of consolidations for corporations producing financial statements according to IFRS. On the one hand, two new aspects are introduced into ED 10, by way of situations with factual control and with economic dependencies. They tend to require an increase in the number of consolidated companies. However, and at first glance, regarding the duty to consolidate special purpose corporations / structured corporations, no significant changes versus the existing regulations can be recognized.

Given this, it would be not a surprise, that the IASB would not only take into account the results of the expected extended debate about ED 10, but that it would also and especially produce more precise guidance as regards the duty for consolidating special purpose corporations to the draft of the standard.

It can be recognized clearly, that the IASB has the strong intention, to improve the information for the users of the financial statements. This is meant to be achieved by way of a significant extension of notes to the financial statements, especially by way of reporting the economic effects of relationships between the balance sheet producing corporation to other consolidated and non-consolidated structured corporations.

These new requirements would represent for corporations that produce balance sheets according to IFRS great challenges for the collection of information as well as regarding their own communication with the capital market.

*Quoted from Börsenzeitung, December 20, 2008
Translated by Helmut Schnabel*

News: Dispute about Regulations for Ratings Agencies are asking for a Loosening - European Union Commission rejects that

December 12, 2008. The rating agencies are asking for improvements of the strict regulations which the European Union wants to impose on them. This relates in particular to the admission in Europe and the question of the liability of its analysts for the results of the rating agencies work. The agencies are hoping that they can achieve changes to the proposals of the European Union Commission.

The European Union Commission had issued, in November 2008, the draft of a decree which would only recognize such rating agencies which have asked for a licence at the committee of the European Association of Securities Supervisors (CESR) in Paris. Licensings of other countries like the USA or Japan will not be recognized. In the future, the licence will be given out by the national supervisory agency of a European country, in which the respective rating agency is residing. This, and other regulations, are meant to secure the quality of the ratings in the future. The critique especially against the three big rating agencies Standard & Poor's, Moody's and Fitch, centers essentially on that it is said, that they have underestimated the risks of complex financial products and that they have thus contributed to the collapse of banks and exchanges.

It is the position of Standard & Poor's, that a regulation can indeed have beneficial effects. But rating agencies are criticizing, that the obligation for licensing does have effects beyond the borders of the European Union. Their argument: Foreign products, such as for instance U.S. government bonds are being rated, as common practice, by the specialists of the rating agencies in their respective country. These U.S. ratings under the proposed new European Union regulation, would in the future be forbidden to be utilized in the European Union. The European Union Commission is now requiring, that only agencies licensed in Europe can issue such ratings. The consequence: Rating agencies registered in Europe must re-produce each U.S.-rating. Otherwise, the U.S. financial products could not be sold in the European Union. The European Union Commission has not taken into account the global functioning of markets, says Torsten Hinrichs, Head of Standard & Poor's Germany.

The European Union Commission in Brussels has a different view on that. The extraterritorial effect of the European Union rating regulation is not an unwanted collateral damage, but it is intention, stated clearly the speaker of European Union Internal Market Commissioner Charlie McCreevy. U.S. rating agencies will have to open affiliates in the European Union. The European Union wants to make sure, that European investors get more security and safety. With strong regulations, the European Union ratings could at the end set a worldwide new standard. As it is reported from the European Union Commission, there is only in one subject still room for manoeuvre: For local rating agencies, which are servicing very small markets, one could eventually make an exception from the strict regulation. Especially in Germany, there exist a few such small agencies. But for the big rating agencies, the regulations should not be loosened. Still, the British government is exercising massive pressure to this regard. But in Brussels, one does not expect that the British will impose their position on the European Finance Ministers Council.

This also relates to the second subject which raises opposition at the rating agencies: Analysts are intended to be put in a position where they can be legally sued for wrong ratings. Warns Hinrichs of S&P from the consequences: An analyst, in the future, will rather issue a lower rating, in order not to be held responsible for eventual losses. The dilemma is, that a too low rating is as much wrong as a too high rating. The way, how an agency is achieving its results, can be regulated, but not the final result, says Hinrichs.

The proposed regulation of the European Union Commission for the rating agencies can be passed, at the earliest, during 2009.

In order to make the rating agencies less vulnerable to conflicts of interest, the proposed European Union regulation states, that rating agencies should at least have three independent managing directors, who are not financially dependant from the respective rating agency. At least one of them must have professional knowledge about securitizations and structured financial products.

Another tightening aspect of the proposed regulation is, that rating analysts should evaluate the same client during a maximum period of four years. After that, they must change to another client's evaluation. Also, it will not be allowed to the rating agencies in the future anymore, to provide advice to their customers about how they could improve their credit worthiness. Should there be conflicts of interest with the customers, then the agency must publish such conflicts.

Quoted from Handelsblatt, December 12, 13, 14, 2008

Translated by Helmut Schnabel

News: State Owned Fund with 20 Billion € France Protects Its Industry

Paris, November 20, 2008. France wants to provide 20 billion € to its state owned funds for the protection of the domestic industry. This was announced by President Nicolas Sarkozy. However, only 6 Billion € are available for the fund in terms of liquidity. We want to use the crisis as a chance for the further development, said Sarkozy. The new fund for strategic investments is planned to be put under the management of the state owned corporation Caisse des Dépôts (CDC). The 20 billion € shall come, by one half each, from the state and from the CDC. Seven billion € will be made available by way of participations in the form of securities, the remainder will be brought in by way of cash. The state wants to infuse participations in Renault and Air France, CDC wants to infuse its participations in French major industrial groups. The remainder should be financed by way of new debt. Sarkozy emphasized, that the French fund can also enter into alliances with European and extra European state owned funds, as long as they are transparent enough.

Sarkozy said, that he will not permit that entire industries will vanish as a consequence of the crisis. As an example he named the automobile industry which employs 10 percent of the working population of France. The fund must take care, that the country will not loose any key industries. Decision centres shall remain in France, by this way. The country must continue to build cars, ships, trains and air plains. Originally one has expected in France a higher infusion of funds into the new state owned fund. But because of the high governmental indebtedness, the budget has become smaller. In spite of this, the French state owned fund will be among the largest state owned funds in the world. The CDC has a central role in the response by France to the economic crisis. This institution was established in the 19th century and is presently invested in round about 1/3 of the enterprises in the stock exchange index CAC-40 as the largest share holder. In addition to that, it is administering the deposits resulting from tax incentivised savings books, and it also finances welfare housing projects and the development of the local communities.

Two examples for the actions of the fund do exist already. Its participation in the French ship building company Chantiers d'Atlantiques of 34 %, which the state has bought recently, in order to avoid a sell off to Korea, will come under the roof of the new fund. In addition to that, the supplier to the airline industry Daher will be equipped with 58 million new equity of the new fund, the state will have an ownership of 49 %, the CDC of 51 %. In CDC circles, however, there is the fear, that the relative independence from the state will now be lost.

*Quoted from Frankfurter Allgemeine Zeitung, November 21, 2008
Translated by Helmut Schnabel*

IAFEI news, activities

The IAFEI Board of Directors Meeting, on December 14, 2008, has elected the following IAFEI officers for the new calendar term 2009:

Chairman	Daniel Burlin, France
Vice Chairman	Victor Lim, Philippines
Secretary	Alfredo Parungao, Philippines
Treasurer	Dr. Ronald Bunzl, Spain
Area President Asia	Hiroshi Yaguchi, Japan
Area President Africa/ Middle East	Paolo Bertoli, Italy
Area President Europe	Marc Ugolini, France

In addition, the IAFEI Board of Directors Meeting made the following recruitment:

Executive Director	Helmut Schnabel, Germany
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In addition, the IAFEI Board of Directors Meeting made the following re-appointments:

Chairman, IAFEI Taskforce Rating Asia	Zhang Chengdong, China
Chairman, IAFEI Taskforce Rating Europe	Gabriele Fontanesi, Italy