International
Finance & Treasury

World Trade Executive
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Weekly Report for International Finance Executives

May 21, 2001

Systems and Possibilities

Today, the road to true global treasury management is under construction by both banks and systems providers.

Erika Morphy

At first glance the rules for an effective global cash management system can seem deceptively simply, at least in theory:

- **examine the cash flow positions of all your subsidiaries to understand how the money flows in and out of each location;**
- **evaluate your tax obligations in each country and how they affect taxes in your home country;**
- **establish a banking relationship with at least one global bank and maintain local relationships in each country in which you are operational; and**
- **unless there are compelling reasons to the contrary, centralize, centralize, centralize.**

There is no rocket science involved with the last maxim. Among several subsidiaries, especially if they are spread across national borders, inevitably there will be short-term cash winners and losers. Centralizing in one structure evens out the monetary shortfalls and excess cash positions. Companies are then able to take advantage of strategies such as cash pooling (in which a company links its various

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50 Ways to Lose Your Money

In the era of risk management convergence, financial and non-financial risks facing banks and industrial groups.

Warren Edwardes, Delphi Risk Management Limited

"To put it simply and directly, if the bosses do not or cannot understand both the risks and rewards in their products, their firm should not be in the business." ***William J. McDonough*, President, *Federal Reserve Bank of New York.***

Acquisition Risk: Do you really know what you are buying? Even if the price to be paid to the receivers is nominal, what is the true value of assets and liabilities of the firm you are buying? In some countries, bank accounting is highly creative. On the other hand, as the target of acquisitive companies, are you spending too much management time fending off predators?

Careless Error Risk: Over-confidence leads to errors. I still vividly remember as a raw but cocksure dealer nearly twenty years ago, saying, "buy dollars" when I meant, "buy pounds." It was highly embarrassing but it was quickly sorted out. Fix the problem immediately.

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Early Birds

The first wave of foreign portfolio investors returning to Japanese capital markets is taking the long view of the economy.

Scott E. Pardee

What is called the "January effect" in the U.S. stock market is starting about now in Japan.

At this time of year, the Japanese stock market tends to perk up. In recent years, prior to the March 31st fiscal yearend, banks and their counterparty companies in cross shareholdings have sold off some of those shares, depressing the market by adding to supply. Substantial transactions along those lines also occurred this March.

April is pretty much a lost month, as political leaders debate whether they will pass an extra spending package, a lugubrious subject since Japan already has a monumental fiscal deficit and these packages are loaded with pork-barrel spending. In early May, Japan takes a holiday for Golden Week. By mid-May, however, Japanese fund managers have projected their cash flows for the coming year, determined their asset allocations between domestic vs. foreign assets, bonds vs. stocks, and among sectors in the stock market, and begun making new commitments in the markets.

What is called the "January effect" in the U.S. stock market starts about now in Japan.

For years, of course, foreign portfolio managers have underweighted Japan, but, at this point

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Exchange Strategies

The dynamics seem to have shifted away from the Triad, and are to be found as far afield as Australia, Mexico and Britain.

Brendan Murphy

The (Citibank-Banacci) deal's cash component, the largest such transaction in Latin banking history, guarantees extremely strong flows into the peso through the fourth quarter.

The Mexican peso has confounded our expectations of an eventual sell-off from recent strong levels, assisted in particular by the news that *Citibank* will acquire *Grupo Financiero Banamex-Accival*, better known as *Banacci*, for $12.5 billion, representing a 40 percent premium over the company's pre-announcement closing price on the *Bolsa*.

The deal's $6.25 billion cash component, the largest such transaction in Latin banking history, guarantees extremely strong flows into the peso through the fourth quarter of the year, when the transaction is expected to be completed.

The announcement galvanized the peso late last week, propelling it through the important psychological dollar-peso support level of MXN9.00 on a 2.07 percent daily gain. Follow-on buying drove the currency to nominal and real exchange rate levels not seen since the mid- to late-1980s, as the peso closed out the week at MXN9.00,

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International
Finance & Treasury

The International Business Information Source™
(ISSN 1070-9215)
Vol. 27, No. 21
May 21, 2001

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Published Weekly (except the first week of September and last week of December) For Subscribers Only

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Subscription Information: Annual subscription: US$1295 (add $50 for non–US postage) Single copy: US$26

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bank accounts at one bank so the aggregate balance is pooled without the need to transfer funds) or cash sweeping (in which a bank sweeps or transfers the account balances across borders to a main account so each participating account is brought to zero).

The extra cash that often results also comes in handy when financing an expansion for example. It also allows a company to negotiate loans as one entity.

So, simply follow these steps, and at the end of the day, will you have structured a world class global treasury operation? As any financial executive at even the smallest sized international company can tell you, reality tends to get in the way.

There are the document-intensive requirements to prove that loans and other transactions between a regional treasury and a local subsidiary are made based on arm's-length pricing. Then, there are those countries that effectively put the skids to the practice of notional pooling, because it is viewed as an intercompany loan, even though the actual cash has not moved from one account to another. There are withholding taxes on cross border cash flows that are still applicable, even with the existence of a double taxation treaty. There is the reluctance of local banks to integrate into your system.

Finally, there are executives in far flung subsidiary locations who seem to lose all sense of financial rationality when faced with the prospect of the parent company sweeping excess cash out of their account on a regular and automated basis.

These problems have not gone away. Indeed many companies—for all the benefits that a centralized cash management structure brings—have yet to pool their resources in such a manner for these reasons.

However, new financial applications—specifically, global treasury systems—are helping companies address and coordinate them, as well as more efficiently integrating and scheduling their cash management, payment and collections processes. Many of these new applications are being provided by banks, but an increasing number are being marketed by private vendors. Next January, when the euro will be completely phased in, replacing the legacy

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Global treasury systems are helping companies address and coordinate problems, as well as more efficiently integrating and scheduling cash management, payment and collections processes.

Reinventing Leonardo

The latest synthetic transaction from ***Banca Commerciale Italiana*** transfers risk on its aircraft finance portfolio.

George Cassidy

Milan-based *Banca Commerciale Italiana* (BCI) is one of the world's leading players in terms of credit derivatives, behind only a handful of the biggest U.S. banks. It has used its resources and expertise to generate synthetic securitization transactions, including *Scala 1* and *Scala 2*—both of which were described in previous issues of *F&T*— shedding credit risk associated with its asset portfolio. The latest of these synthetic transactions, *Leonardo plc*, does the same for the bank's aircraft financing activities.

BCI is exposed to credit risk from airlines and aircraft manufacturers as a result of loans for aircraft purchases. The bulk of these are accomplished in the form of tax-enhanced leases, employing special purpose vehicles, a common structure in this industry. The airlines lease aircraft from the SPVs and the lease payments service the SPVs' loans outstanding from the bank.

BCI is transferring the risk by executing a credit default swap (CDS) with ***Merrill Lynch International*** (MLI), with MLI's performance thereunder guaranteed by its parent, ***Merrill Lynch & Company*** (ML). MLI is entering into offseting CDS transactions with a series of counterparties, including Leonardo (see structure diagram) to hedge its exposure.

The initial reference portfolio for the swap will consist of more than a hundred loans with a principal amount slightly in excess of $1 billion. All but about 3 percent of this amount are loans, in the form of either direct loans or tax leveraged leases, secured by aircraft. The portfolio is relatively heavily skewed toward national flag airlines, such

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BCI is exposed to credit risk from airlines and aircraft manufacturers, principally in the form of tax-enhanced leases, employing special purpose vehicles.

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practically every year, they are itching to get back into that market. The desire arises from their hope that, this time, the Japanese economy will grow, corporate profits will soar, and the *Nikkei* index will trend upwards. When Japanese investors begin to bid up stocks, foreign investors are quick to join.

That process is again underway, except that, this year, foreign investors seem to be main buyers. Brokerage houses selling Japanese stocks to American investors are reporting lively demand; ***Merrill Lynch*** in Japan has such a slow order flow from retail customers that it has announced a cost cutting drive.

If (Koizumi) emerges from the elections with a mandate for change, Japan's economy may at long last revive. When that happens, Japanese stocks will also rise sharply, quickly.

The difference is foreign investors' perception of the new Prime Minister, *Junichiro Koizumi*, and the reform proposals he has set forth since taking office on April 26th. Set these against the caution flags that local investors see being raised.

Koizumi wants to cut the fiscal deficit, cap the issuance of new bonds, and get the banks to write down their bad debt. By the official forecast, Japan's gross domestic product (GDP) is expected to grow by 1.7 percent this fiscal year, but private forecasters are looking at 1 percent tops. Indeed, looking at the latest figures, GDP may already be slipping.

Koizumi has warned reforms might cause a short-term recession, indicating it is not a good time to buy stocks, especially in light of earnings of Japanese companies recently. Only auto companies seem to be doing well, because of the weak yen.

Koizumi also confronted "hot button" political issues. These include changing the constitution to allow direct election of the Prime Minister and revising language relating to Japan's military posture. He has an 80 percent approval rating, but faces an upper house election in June and a lower house election in September. Imminence of the elections is also reason for Japanese investors to hesitate.

Foreign investors have a different time frame for Japan. Koizumi has taken on the power brokers, set forth a full slate of reform proposals, and gained personal popularity. He has stopped central bank bashing at the Finance Ministry, and the yen bashing elsewhere in the government. If he emerges from the elections with a mandate for change, Japan's economy may at long last revive. When that happens, Japanese stocks will also rise sharply, quickly.

So far, a few U.S. analysts have recommended that investors move from "underweight" to "neutral" in Japanese stocks. From international portfolios, that's worth $10 billion of buying power at least. If, six months from now, Japan becomes a "buy," the early birds will be rewarded, as more tens of billions of dollars pour into that market, from domestic as well as international investors. ❑

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a weekly gain of 2.29 percent. The action triggered a 5.5 percent rally on the Mexico City *Bolsa*, sending Banacci shares up 29 percent.

The question facing dollar-peso market participants is whether the peso can maintain such high levels, with the Citibank-Banacci deal certainly discounted in full and other positive news priced in.

Despite the immense wave of bullishness, we are a bit cautious that the market may be primed for a significant round of profit-taking that could take dollar-peso back toward MXN9.25. At that level, however, most participants would probably perceive an opportunity to reposition.

There are a number of positive fundamental factors at work that could combine to keep the peso-dollar rate near the MXN9.00 level for some time.

There are a number of positive fundamental factors at work that could combine to keep the peso-dollar rate near the MXN9.00 level for some time, despite the loosening of some ***Bank of Mexico*** (Banxico) policy supports on the back of the Citi-Banacci deal. Therefore, accounts should be prepared to trade dollar-peso in a range between MXN8.95 and MXN9.35 at the outside, barring more Banacci-type surprises.

Weaker Demand Equals a Stronger Peso

Part of the good news for the currency is, ironically, that Mexico has fallen into recession.

The 1.9 percent year-on-year gain in first-quarter real gross domestic product (GDP) nonetheless translated into a quarterly decline, seasonally adjusted and annualized, of 1.2 percent, following a 3 percent drop in the fourth quarter of 2000. ***J. P. Morgan Chase*** analyst *Alfredo Thorne* observed that this was the sharpest activity drop since the 1995 recession, and considerably sharper than the modest 0.6 percent quarterly decline following the late-1998 Russian crisis.

Thorne has trimmed his full-year forecast to growth of 1.3 percent from 2 percent previously, adding that he believes "the worst is over" and that the Mexican economy will expand at a 2 percent rate in the second and third quarters, and recover to a 5.3 percent pace by yearend 2001.

This picture is generally peso-positive because the slowdown has impacted on domestic demand, which should eventually translate into reduced demand for imported goods. That said, imports have

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Bank of America's World Value of the Dollar as of May 18th

The table below gives the rates of exchange for the U.S. dollar against various currencies as of Friday, May 18th, 2001. The exchange rates are middle rates between the buying and selling rates as quoted between banks, unless otherwise indicated. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are not intended to be used as a basis for particular transactions. *Bank of America* does not undertake to trade in all listed foreign currencies, neither does *Bank of America* assume responsibility for errors.

EUR=$0.88277 SDR=$1.26308 3-month LIBOR 4.00 3-month SIBOR 4.00 6-month LIBOR 4.03 6-month SIBOR 4.03

Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani (c)	4750.00
Albania	Lek	146.45
Algeria	Dinar	78.0105
American Samoa	US$	1.00
Andorra	Peseta	188.4817
Andorra	Franc	7.4307
Angola	Kwanza (4)	18.2458
Antigua	E. Car. $	2.70
Argentina	Peso	1.00
Armenia	Dram	544.68
Aruba	Florin	1.79
Australia	Dollar	1.8981
Austria	Schilling	15.5876
Azerbaijan	Manat	4589.00
Bahamas	Dollar	1.00
Bahrain	Dinar	0.377
Bangladesh	Taka	54.10
Barbados	Dollar	2.00
Belarus	Ruble	1240.00
Belgium	Franc	45.697
Belize	Dollar	2.00
Benin	CFA Franc	743.0667
Bermuda	Dollar	1.00
Bhutan	Ngultrum	46.937
Bolivia	Boliviano (f)	6.54
Bolivia	Boliviano (o)	6.07
Bosnia Herz.	Konv. Marka	2.2156
Botswana	Pula	5.6022
Bouvet Island	Krone	9.0749
Brazil	Real	2.3025
Brunei	Dollar	1.8085
Bulgaria	Lev	2.2236
Burkina Faso	CFA Franc	743.0667
Burundi	Franc	818.45
Cameroun	CFA Franc	743.0667
Canada	Dollar	1.5357
Cape Verde Is.	Escudo	122.447
Cayman Is.	Dollar	0.82
Cent. Af. Rep.	CFA Franc	743.0667
Chad	CFA Franc	743.0667
Chile	Peso (m)	606.95
Chile	Peso (o)	518.37
China	Renminbi	8.2768
Colombia	Peso (o) (1)	2364.00
CIS	Ruble (m)	29.1125
Comoros Rep.	Franc	557.30
Congo Rep.	CFA Franc	743.0667
Congo Dem. Rep.	Franc (3)	4.4999
Costa Rica	Colon	325.88
Cote d'Ivoire	CFA Franc	743.0667
Croatia	Kuna	8.3168
Cuba	Peso	1.00
Cyprus	Pound *	1.5215
Czech Republic	Koruna	39.015
Denmark	Krone	8.4858
Djibouti	Franc	175.00
Dominica	E. Car. $	2.70
Domi. Rep.	Peso	16.10
Ecuador	Sucre (o) (2)	1.00
Egypt	Pound	3.8883
El Salvador	Colon (d)	8.752
Eq'tl. Guinea	CFA Franc	743.0667
Estonia	Kroon	17.7873
Ethiopia	Birr (o)	8.267
European EMU	Euro*	0.8828
Faeroe Is.	Krone	8.4858
Falkland Is.	Pound *	1.4272
Fiji	Dollar	2.2766
Finland	Markka	6.7353
Fr. Pacific Is.	Franc	135.1028
France	Franc	7.4307
French Guinea	Franc	7.4307
Gabon	CFA Franc	743.0667
Gambia	Dalasi	15.675
Georgia	Lari	1.975
Germany	Mark	2.2156
Ghana	Cedi	7457.75
Gibraltar	Pound *	1.4272
Greece	Drachma	386.0009
Greenland	Krone	8.4858
Grenada	E. Car. $	2.70
Guadeloupe	Franc	7.4307
Guam	US$	1.00
Guatemala	Quetzal	7.8115
Guinea Rep.	Franc	1920.00
Guinea Bissau	Franc	743.0667
Guyana	Dollar	180.50
Haiti	Gourde	23.75
Honduras	Lempira (d)	15.35
Hong Kong	Dollar	7.7999
Hungary	Forint	293.545
Iceland	Krona	100.80
India	Rupee (m)	46.936
Indonesia	Rupiah	11300.00
Iran	Rial (o)	1752.50
Iraq	Dinar (o)	0.3124
Ireland	Punt *	1.1209
Israel	New Shekel	4.142
Italy	Lira	2193.4026
Jamaica	Dollar (o)	45.45
Japan	Yen	123.315
Jordan	Dinar	0.7108
Kazakhstan	Tenga	145.45
Kenya	Shilling	78.90
Kiribati	Aus. Dollar	1.8981
Korea, North	Won	2.20
Korea, South	Won	1303.95
Kuwait	Dinar	0.3079
Kyrgyzstan	Som	49.493
Laos	Kip	7600.00
Latvia	Lat	0.6298
Lebanon	Pound	1514.25
Lesotho	Maloti	7.957
Liberia	Dollar	1.00
Libya	Dinar	0.5362
Liechtenstein	Franc	1.7441
Lithuania	Litas	4.0011
Luxembourg	Franc	45.697
Macao	Pataca	8.0573
Madagascar	Franc	6581.00
Malawi	Kwacha	76.00
Malaysia	Ringgit	3.80
Maldive Is.	Rufiyan	11.77
Mali Republic	CFA Franc	743.0667
Malta	Lira *	2.1969
Martinique	Franc	7.4307
Mauretania	Ouguiya	251.48
Mauritius	Rupee	28.665
Mexico	New Peso	8.985
Moldova	Lei	12.6642
Monaco	Franc	7.4307
Mongolia	Tugrik (m)	1092.00
Montserrat	E. Car. $	2.70
Morocco	Dirham	11.5939
Mozambique	Metical	19500.00
Myanmar	Kyat	6.7363
Namibia	Dollar	7.9475
Nauru Is.	Aus. Dollar	1.8981
Nepal	Rupee	75.0278
Neth. Antilles	Guilder	1.79
Neth. Antilles	Florin	1.79
Netherlands	Guilder	2.4964
New Zealand	Dollar	2.3502
Nicaragua	Gold Cordoba	13.27
Niger Rep.	CFA Franc	743.0667
Nigeria	Naira (m)	112.50
Norway	Krone	9.0749
Oman Sultanate	Rial	0.385
Pakistan	Rupee	61.675
Panama	Balboa	1.00
Papua N.G.	Kina	3.0628
Paraguay	Guarani (d)	3820.00
Peru	Nuevo Sol (d)	3.6005
Philippines	Peso	50.33
Pitcairn Island	NZ Dollar	2.3502
Poland	Zloty (o)	3.9685
Portugal	Escudo	227.1056
Puerto Rico	US$	1.00
Qatar	Riyal	3.6408
Rep. Macedonia	Dinar	64.045
Rep. Yemen	Rial (a)	161.458
Ile de la Reunion	Franc	7.4307
Romania	Leu	28528.50
Russia	Ruble	29.1125
Rwanda	Franc	435.50
San Marino	Lira	2193.4026
Sao Tome/Principe	Dobra	8203.50
Saudi Arabia	Riyal	3.7505
Senegal	CFA Franc	743.0667
Seychelles	Rupee	5.70
Sierra Leone	Leone	1899.095
Singapore	Dollar	1.8085
Slovakia	Koruna	49.184
Slovenia	Tolar	247.325
Solomon Is.	Solomon $	5.2356
Somali Rep.	Shilling (d)	2620.00
South Africa	Rand (c)	7.957
Spain	Peseta	188.4817
Sri Lanka	Rupee	90.475
St. Christopher	E. Car. $	2.70
St. Helena	Pound *	1.4272
St. Lucia	E. Car. $	2.70
St. Pierre/Miq'lon	Franc	7.4307
St. Vincent	E. Car. $	2.70
State Cambodia	Riel	3835.00
Sudan	Pound (c)	2560.00
Sudan	Dinar	256.00
Suriname	Guilder	981.00
Swaziland	Lilangeni	7.957
Sweden	Krona	10.2547
Switzerland	Franc	1.7441
Syria	Pound	52.50
Taiwan	Dollar (o)	32.95
Tanzania	Shilling	888.50
Thailand	Baht	45.46
Togo Rep.	CFA Franc	743.0667
Tonga Is.	Pa'anga	2.0964
Trinidad/Tobago	Dollar	6.17
Tunisia	Dinar	1.4504
Turkey	Lira (7)	N/A
Turks & Caicos	US$	1.00
Tuvalu	Aus. Dollar	1.8981
Uganda	Shilling	1790.10
Ukraine	Hryvnia	5.4112
United Kingdom	Pound *	1.4272
Uruguay	Peso (m)	11.3925
U.A.E.	Dirhan	3.673
Uzbekistan	Sum	775.00
Vanuatu	Vatu	141.80
Vatican City	Lira	2193.4026
Venezuela	Bolivar (d)	715.255
Vietnam	Dong (o)	14606.00
Virgin Island BR	US$	1.00
Virgin Island US	US$	1.00
West. Samoa	Tala	3.4388
Yugoslavia	New Dinar (6)	67.207
Zambia	Kwacha	3375.00
Zimbabwe	Dollar (5)	56.875

(n/a) Not Available. * U.S. Dollar per national currency unit. (a) Parallel. (c) Commercial. (d) Free market. (f) Financial. (m) Market. (o) Official. (1) Colombian peso allowed to float freely on 9/27/99. (2) Ecuador adopts U.S.dollar. (3) Congo Democratic Republic, formerly Zaire Democratic Republic, Congolese franc is new currency. (4) Angolan kwanza revalued on 12/13/99. (5) Zimbabwe dollar delvalued by approximately 24 percent on 2/8/00. (6) Yugoslavian new dinar is now "managed float," linked to euro/mark. (8) 7urkish lira allowed to float freely on 2/22/01.

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remained reasonably strong through the first four months of this year, averaging $1.39 billion in the first quarter with Morgan forecasting imports of $13.5 billion in April. That would equate to a pickup in the trade deficit to $809 million, compared with the first-quarter average of $708 million.

A pronounced weakening in employment, particularly in the export sector, should weigh upon the spending enthusiasm of Mexican consumers. Even setting trade figures aside, strong oil prices and massive inbound investment ensures a healthy current account balance going forward.

Banxico trimmed its longstanding *corto*, or short position in the money market, to MXN350 million from MXN400 million, the first such reduction since 1996.

So, why are we still cautious on the peso?

Banxico policy shifts are one reason not to see a permanently appreciating currency. Already, the peso has appreciated 7.10 percent against the dollar year-to-date, notes Citibank emerging market currency strategist *Callum Henderson*, despite the rally in the broad U.S. dollar index to multi-year highs. This appreciation enabled Banxico to implement a number of measures on May 18th, which together translate into lessened central bank support for the peso.

Most prominently, Banxico trimmed its longstanding *corto*, or short position in the money market, to MXN350 million from MXN400 million, the first such reduction since 1996. The bank also said it would no longer intervene when the peso slips by more than 2 percent from the previous official daily fixing level.

More constructively for the peso, Banxico said it will no longer auction the dollar puts that have helped bolster foreign exchange reserves by some $12.1 billion.

J. P. Morgan Chase currency strategists conclude that, “Removing the dollar put option mechanism on its own would normally have strengthened the peso, while lowering the *corto* would have had the opposite effect—a slight peso weakening.

“Strong foreign direct investment (FDI) flows that are likely to continue have significantly bolstered the peso, while the *corto*, as more of a near-term signal to participants, is less of a consideration for dollar-peso going forward. As a result, there are now fewer obstacles between the peso and its further strengthening,” Morgan Chase concludes. It is recommending to clients establishment of three-month, out-of-the-money MXN calls, struck at MXN8.75, as a lower-cost way to position for what they consider to be a “very bullish Mexican peso scenario” in view of the market’s expectations for continued strong FDI, fiscal reform and a possible rating agency upgrade.

From our perspective, accounts that naturally accumulate pesos may wish to hold long positions and look for better levels.

From our perspective, accounts that naturally accumulate pesos may wish to hold long positions and look for better levels. However, we would be inclined to take profits as of MXN8.85/90, rather than looking for a run to the implied MXN9.75 target in the recommended Morgan Chase position

Actual and Forecast FX Ranges, *F&T* Outlook for Major Currency Pairs
(Exchange Rates from Thomson Financial/IFR, Boston)

Currency Pair	*Prior Range*	*Forecast Range*	*Last Week*	*Last Seen*	*Change (%)*	*Two-Week Outlook*
USD/Euro	0.8720–0.8880	0.8525–0.8925	0.8760	0.8790	+0.34%	Cautious
DEM/USD	2.2025–2.2429	2.1914–2.2942	2.2327	2.2251	–0.34%	Cautious
JPY/USD	122.40–124.05	122.25–125.25	122.40	123.55	–0.94%	Positive
JPY/Euro	107.00–109.85	106.75–110.25	107.20	108.50	–1.21%	Positive
JPY/DEM	54.71–56.17	54.58–56.37	54.81	55.48	–1.21%	Positive
USD/GBP	1.4150–1.4385	1.4225–1.4425	1.4180	1.4375	–1.38%	Neutral
GBP/Euro	0.6105–0.6210	0.6100–0.6250	0.6170	0.6110	+0.97%	Neutral
DEM/GBP	3.1495–3.2037	3.1293–3.2063	3.1699	3.2010	–0.98%	Neutral
CHF/USD	1.7255–1.7550	1.7250–1.7650	1.7505	1.7450	+0.31%	Neutral
CHF/Euro	1.5300–1.5355	1.5300–1.5400	1.5335	1.5340	–0.03%	Neutral
SEK/Euro	8.9400–9.0810	8.9000–9.1000	8.9675	8.9785	–0.12%	Neutral
CAD/USD	1.5320–1.5560	1.5275–1.5625	1.5495	1.5330	+1.06%	Neutral
USD/AUD	0.5155–0.5295	0.5175–0.5425	0.5210	0.5280	–1.34%	Positive
MXN/USD	8.9540–9.2150	8.9500–9.3500	9.2110	9.0000	+2.29%	Cautious
BRL/USD	2.2790–2.3430	2.2500–2.4000	2.2940	2.2990	–0.22%	Neutral

Foreign exchange pairs given per U.S. convention. Percent change refers to numerator in respective currency pair; positive change means that the denominator, or base currency, has gained. Outlook refers to base currencies, with the exception of the Canadian dollar, Mexican peso and Brazilian Real; in those cases it refers to the two-week outlook for the CAD, MXN or BRL against the USD.

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(although the bank strategists don't make clear if they expect these options to end up in the money, or if anticipated gains are predicated on option appreciation on a run-up short of MXN8.75).

Whether the former or the latter, the Morgan team doesn't expect the peso to stay strong indefinitely: it is seen depreciating to MXN9.60 by the end of this year (though this target was adjusted from the earlier year-end target of MXN10.20), though holding in the range of MXN9.00 to MXN9.20 until September, they add.

Steady to Weaker Euro

When foreign exchange markets start trading off the re-weighting of the ***Morgan Stanley Capital International*** index, it is a good sign that participants have run out of better stories on which to deal.

The thinking is that the yen and the euro will suffer from adjustment of the relative weightings of equity portfolios, and that the dollar and sterling should gain, given the relative increase in U.S. and UK share values in the index. However, as Citibank global currency strategy chief *Bob Sinche* observes, the near-term impact will be limited as new weightings won't be implemented until November, 2001, and May, 2002. Certainly some portfolios will anticipate the move, but those managing against a benchmark will move more slowly.

Euro-dollar, in particular, is probably in for a period of slogging along without much movement in either direction. Neither the relative growth nor the interest rate arguments carry much weight at this stage of the game: U.S. activity has slowed, European growth no longer looks impervious to the global deceleration; U.S. rates have been slashed, but European rates have now been cut and stand to come down further.

A kind of cyclical harmonization seems to be in process, leaving the currency punter with no strong reasons to prefer one currency over the other—though on a long-term view the dollar would seem to have the advantage as the U.S. leads the way stronger.

Analysts consequently are turning their sights to second-rank currencies, including the Australian dollar and the British pound sterling.

Aussie is starting to respond to commodities price moves as participants look at the implications of global recovery, particularly in the Asia-Pacific region. A Japanese recovery of even the most modest proportions could have significant price implications for the Australian dollar, given Australia's strength in natural resources exports to the region.

Citibank analysts cite the likely yen decline down the road, once enthusiasm for new Prime Minister *Junichiro Koizumi* fades, as a particular factor in liking Aussie-yen better than dollar-yen as a play. From current levels around ¥64.86/AUD1 they see the cross moving to ¥67.20 on a trading view.

Sterling is also looking more attractive, Citi analysts conclude, citing the surprise surge in UK April retail sales to a 5.9 percent year-on-year pace, the best pace since early 2000.

"This represents further evidence, after robust consumer confidence, the housing market recovery, strong average earnings and the steady unemployment decline, that UK domestic demand remains buoyant." On such grounds, the sterling looks likely to benefit more from near-term weakness in the U.S. dollar than the euro, Citi concludes, given the contrast between brisk UK activity and a more sluggish tone to European activity, particularly in the German industrial heartland.

True, but only up to a point, we would caution. We had been looking for sterling to do better against the dollar, but have been disappointed with cable's lackluster performance despite the Fed's aggressive rate cuts and generally stronger UK economic activity.

Our conclusion has been that, whether or not Britain exchanges sterling for the euro, sterling is now closely tied to the fortunes of the euro and will find it more difficult to rally strongly against the dollar without a compelling story. The risk for punters in cable is that the UK's stronger current performance could be overshadowed by a prospectively strong U.S. recovery that would take the wind out of cable's sails (not that it has managed much of a move in any event being seemingly mired in a $1.40 to $1.45 range).

We like Aussie much better—it is a more straightforward play on global recovery and Australia's own relatively encouraging economic prospects. It seems to have gotten mired a bit in its current range from $0.5150 to $0.53. However, we would not be surprised if dealing interest in it as a promising U.S. dollar proxy were to provide what is needed to energize through $0.53 towards $0.55. That said, however, there is probably enough residual caution to restrict upside to $0.54 over the coming weeks, even though it is probably not too aggressive to set $0.55 as a quarter-end target. ❑

Foreign exchange analysis and recommendations by Brendan Murphy, founder and chief executive of ***fxotica.com****, The Global Currency Channel.* ***Market News International****, New York, and* ***Thomson Financial-IFR****, Boston, have provided information and data for this report.*

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***50 Ways*, from Page 1**

Competitive Risk: Don't put off that product too long, even if it is going to compete with existing products. Somebody else will build a better mortgage product if you do not. Like Virgin Direct. Don't rely on superior current market share. Be innovative or ready to immediately react to competitors.

Commodity Risk: Are your customers subject to gold or other commodity prices? Gold or copper producers could have their borrowing liabilities linked to the gold price. See *Energy Risk*.

Communication Risk: Send that confirmation now. See *Language Risk*. And avoid jargon. Don't talk about strangles and straddles. What is really going on in the deal? Tell it like it is.

Competence/Understanding: If you don't understand your dealers, don't let them do it. Don't be afraid of your own ignorance. Take a course, or buy a book. Don't be afraid to ask seemingly stupid questions. See *Fraud (Staff) Risk*.

Concentration of Assets Risk: Large exposure risk is obvious, and there are central bank limits in most (but not all) countries. Sometimes, governments direct banks to lend to certain champion industries. Later, of course, they have to call the ***International Monetary Fund***.

Japanese firms suffered from economic exposure with respect to the (South Korean) won. Few corporate treasurers hedge economic exposure.

Concentration of Liabilities Risk: Diversify your liabilities. Retail bankers have fewer liquidity problems than do wholesale bankers. Do not place yourself at the mercy of a few lenders. See *Liquidity Risk*.

Concentration of Business Risk: With the merger of ***Citicorp*** and ***Travelers*** into ***Citigroup***, it seems that financial supermarkets are again the fashion. On the other hand, ***Barclays Capital*** advertises, "Stick to your strengths." If the market moves and regulations change, can you reinvent your institution?

Convertibility Risk: Also known as "deliverability risk." Can the currency be converted and delivered into a freely tradable currency? Non-deliverable forwards are widely used in Asia and in Eastern Europe, partly in an attempt to neutralize this type of risk.

Country Risk: Do you really understand what is happening in Indonesia or Korea? Can you control your Asian subsidiary from afar without offending everyone? Or your aggressive California subsidiary or branch without killing motivation?

Credit Risk: How much has the customer borrowed elsewhere? Has your client used off-balance sheet finance excessively? Will the parent or government really stand by that bank? You could buy these new fashionable credit derivatives. See *Legal Risk*. Know your customer—not just the firm, but the human being you are dealing with.

Cultural Risk: "My word is my bond" is the rule in London. Be warned, it does not apply everywhere, even after contracts have been exchanged. Contracts are sometimes seen as a basis for negotiation. See *Fraud (Customer) Risk*.

Currency Economic Risk: Japanese producers faced severe competition from Korean producers after the devaluation of the Korean won. Japanese firms suffered from economic exposure with respect to the won. Few corporate treasurers hedge economic exposure.

Currency Translation Risk: Risk of revaluation/devaluation of foreign assets or liabilities as a result of a movement in currency value. No cash flow here, but there may be tax problems. Not many corporate treasurers hedge translation exposure.

Currency Transaction Risk: This is the risk that foreign currency receivables will change in home currency terms. But what is a loss? How are you, as the treasurer, measured? Are you measured against the spot rate outcome, against the forward rate at the time the underlying transaction is made, or against the average exchange rate over the year?

Customer Satisfaction Risk: Do your customers like doing business with you? Will they come back for more of the same? Do they call you for other products?

Disaster Recovery Risk: Are you prepared? If you lose $80 million on interest rate caps, what does the market think of you? Be sure to watch carefully traders who are making substantial profits. If they say it is "arbitrage," make sure it is. Genuine arbitrage is still possible. If the profits are speculative, they will probably turn into losses. See *Fraud (Staff) Risk*.

Economic Activity Risk: A slowdown in

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economic activity will affect your business. Your overhead still has to be covered. A downturn in international trade will effect the foreign exchange and financing business of banks.

Energy Price Risk: Do you have airline customers who could use energy derivatives? Oil producers, such as Mexico, have had the interest rate on their bond liabilities linked to the price of oil. See *Commodity Risk.*

Environment Risk: If you lend to polluters, you may be faced with competition from a bank that does not. See *Image Risk.*

Equity Market Risk: Are you about to launch a rights issue? Use equity derivatives to hedge the issue. But do check regulatory compliance issues to be sure that you cannot be accused of insider trading.

Fraud (Banker) Risk: Has your banker misrepresented that complex geared swap? Make sure you tape all conversations: learn from *Linda Tripp.*

Fraud (Customer) Risk: Will your client say that he did not understand that complex geared swap? All will be fine if the client is "in the money." He will only cry "foul" if things start to go sour for him.

Fraud (Staff) Risk: This often follows a covered-up disaster. See *Disaster Risk.* Watch the traders who don't take holidays. Many an irregularity has surfaced when a trader who never took a holiday fell ill and his position was taken over by a colleague.

Image Risk: A recovery from a bout of bad publicity is extremely difficult. See *Disaster Risk* and *Fraud (Banker) Risk.* Keep the media, rating agencies and your counterparties fully informed of any potential difficulties. Prepare a list of questions and answers for your CEO. No fund manager or treasurer wants to hold an asset or do business with a bank or company that suffers from adverse reporting in the media.

Information Risk: Keep your mouth shut and ears open, especially where the "movers and shakers" socialize. In my experience the most leaky are the most senior. Read the financial press as you commute or travel. Even a small piece of information may be somebody else's missing link. However, beware of the boastful.

Inflation Risk: Many utilities have inflation-linked price controls. Issuing a bond linked to inflation allows them to provide an investment vehicle to pension funds and other savers who seek to generate inflation-adjusted annuities.

Interest Rate Risk: Are you selling fixed rate mortgages? If you are in the property business, even if you are not financing, you suffer from interest rate risk. Demand for property is linked to interest rates. As a retail banker, your checking account business will lose profitability as interest rates fall. Overheads are fixed costs.

Interaction Risk: This is an alias for correlation risk. Is the Hong Kong dollar or Saudi riyal really fixed to the dollar? What if monetary union within Europe fails and the euro collapses?

Language Risk: When your customers or subordinates say "Yes," do they just mean, "I heard you?" See *Communication Risk.* Also, be careful about the symbol "M." It may mean "million" or "thousand."

Legal Risk: Were those nice UK Local Authority swap dealers acting *intra vires*? Do you really think that credit derivatives are not insurance contracts and therefore prohibited to banks in most countries?

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Liquidity Risk: Also known as "solvency risk." Liquidity is much less about holding liquid assets than about managing and diversifying liabilities. Remember the sad case of ***Continental Illinois***. See *Concentration of Liabilities Risk* and *Image Risk.*

Morbidity Risk: Are your staff healthy and drug-free? Don't be too reliant on any one person. Also, is someone likely to affect others' performance through racist or sexist remarks?

Mortality Risk: An extension of *Morbidity Risk.* Copy the Royal Family and take separate flights on trips. Don't even think about buying "key-man insurance." For me, a sure sign of a badly run firm or team is when such insurance is even mooted. The solution is not purchase of insurance but internal hedging; make sure that at least two people can do the job.

Operational Risk: This is everything other

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***Systems*, from Page 3**

currencies in the euro zone, even more third party providers will target this space.

That is the prediction of *Dominique Chesneau*, a partner in the Global Treasury practice of ***PricewaterhouseCoopers, LLP*** (PwC) in Paris. “You can expect to see more virtual treasury centers and more and more portals for cash management and more application providers for treasury management systems,” he says. Already, Chesneau is watching multiple U.S. application service providers (ASPs) vendors entering Europe, offering such solutions.

“You can expect to see more virtual treasury centers and more and more portals for cash management and more application providers for treasury management systems.”

While such tools have been introduced—and even occasionally used by the largest of multinationals companies—in the past, this particular wave of treasury systems products will be different, proponents say. Some are “pure play” treasury applications. Others are new releases from enterprise resource providers (ERPs) such as ***Oracle*** and ***PeopleSoft***. Others address a single aspect of a global treasury operation, such as settlement, payment, or foreign exchange transactions. Many are priced for the middle market.

“What we are doing is unprecedented,” declares *Russell Stern*, chief executive of ***Escrow.com***, a provider of global e-commerce solutions that manage and settle trade transactions. That is a bold statement, but Stern may well be right. Technology has evolved tremendously, allowing certain transactions that would not have been possible even six months or a year ago.

Timing of payments has become so finely tuned that companies are able to plan disbursements months in advance, taking into account such diverse factors as politics, economic and currency fluctuations, or even possible weather patterns.

“By planning it right, a company can literally save thousands of dollars by taking advantage of a strong dollar,” says *Tara Little*, senior product manager at ***Ruesch International***, a global foreign exchange and financial services provider. “We have different tools to better plan and are able to use data of upcoming events—say, a speech by *Alan Greenspan*—to forecast how payments might be affected.”

Consider for example, the recent elections called by Tony Blair, says Little. “That will impact the value of the pound. If you know you have to make payments in the United Kingdom in June, you want to be aware of the elections as you schedule payments.

“Payments are not just a technical, procedural process. They should be strategic as well. You might as well make the market work for you.”

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Indeed it is the return on investment that these systems can deliver that has caused many mid-tier companies to invest in them.

The ERP vendor, PeopleSoft for example “has about five or six people in its treasury department,” says *Mark Stapleton*, director of Product Strategy for Treasury Solutions at the company. “This is due in large part to the automation of the department. We discovered we could save $1.5 million just by managing our own operations.” The company has also saved some $250,000 in interest “just by moving money around when interest rates were lower.”

Stapleton uses the example of a Texas oil company that sells to Panama, among other countries. “They would make a sale and col-

Foreign Exchange Market Options Data

Provided by *Bank of America*

	5/21/01	Year Ago	% Chg. $ Value	Implied Volatility for At–the–Money Options					
				1 Week	1 Month	2 Month	3 Month	6 Month	1 Year
EUR/USD	0.8800	0.8997	2.19%	8.5/ 9.5	10.3/10.5	10.7/11.0	11.0/11.3	11.3/11.6	11.5/11.8
USD/JPY	123.23	107.26	14.89%	6.5/ 9.5	8.9/ 9.2	9.1/ 9.4	9.2/ 9.5	9.9/10.3	10.2/10.6
GBP/USD	1.4400	1.4885	3.26%	6.5/ 7.5	7.6/ 8.0	7.9/ 8.2	8.1/ 8.4	8.5/ 8.8	8.7/ 9.0
USD/CAD	1.5325	1.4958	2.45%	5.5/ 6.5	5.6/ 6.0	5.6/ 5.9	5.7/ 6.0	5.7/ 6.0	5.7/ 6.0
AUD/USD	0.5290	0.5725	7.60%	11.2/12.2	12.0/12.4	12.1/12.4	12.1/12.4	12.1/12.4	12.0/12.5
EUR/SEK	8.9900	8.1881	9.79%	6.0/ 7.0	6.8/ 7.3	6.8/ 7.2	6.8/ 7.2	6.9/ 7.2	6.8/ 7.3
USD/ILS	4.1500	4.1836	–0.80%		4.2/ 4.5	4.3/ 4.8	4.6/ 5.0	5.4/ 5.7	5.6/ 6.0
USD/PLN	3.9725	4.5150	–12.01%		10.3/11.5	11.0/12.0	11.5/12.5	12.1/13.1	12.6/13.6
USD/ZAR	7.9000	7.1650	10.26%		10.8/12.2	11.1/12.1	11.3/12.2	11.5/12.5	11.8/12.6
EUR/JPY	108.50	95.49	–13.62%	10.0/11.0	10.8/11.2	11.0/11.4	11.3/11.6	11.9/12.2	12.1/12.7
EUR/CHF	1.5340	1.5527	1.20%	2.8/ 3.8	3.2/ 3.5	3.4/ 3.7	3.5/ 3.8	3.7/ 3.9	3.7/4.0
EUR/GBP	0.6125	0.6014	–1.85%	6.5/ 7.5	7.2/ 7.5	7.4/ 7.7	7.7/ 8.0	8.2/ 8.5	8.4/ 8.8

Implied Volatilities

EUR/USD vols continue to get marked lower. Such low levels were last seen in Nov., 1999, when the euro was above parity.

JPY vols are slightly lower than Friday. There has not been too much new buying interest, but better demand for JPY puts continues to develop.

GBP vols are steady, though the tone of the market seems to be moving more in favor of GBP. One-month actual volatility is reasonably close to implied volatility.

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lect a wire at headquarters for $100,000. That money needs to be counted as part of a cash position immediately. But the finance department might not get a receivable for a while." Using a global treasury application, an accounting clerk is able to input the wire information directly into the system.

A Dose of Reality

Before global companies begin establishing completely automated centralized cash and treasury management divisions, a cold dose of reality is in order.

Yes, these applications can automate many difficult planning issues. But they are still not perfect tools.

PeopleSoft's Stapleton, for example, foresees the day "when the treasurer will have the ability to log onto a Web site on which the company's entire cash position has been gathered, complete with links to financial institutions. He or she can link to the institutions' investment alternatives, see what money is available, go out and buy what he wants, and have the transactions take place immediately."

However, right now, other issues are also blocking the way. Until countries simplify and harmonize their tax and regulatory regimes, there is only so much that can be done. Also, while banks have definitely become more amenable to interfacing with these independent applications—viewing them more as complements to their products instead of competitors—it usually helps if you are a big customer that they don't want to lose.

Pan-regional cash management strategies outside of North America can be very hard to construct, even with the most advanced treasury systems and technology. The simple fact is that few regions' financial rules are harmonized, including those of the European Union. Rules on cash netting and pooling differ from country to country. Indeed there is practically no such thing as a pan European banking network, regardless of what bank marketing materials will tell you. Truly pan-European banks are relatively rare creatures, restricted to the likes of ***ABN-AMRO, Deutsche Bank*** and a handful of U.S.-based multinational giants

In Asia, the situation is even more extreme. Many companies find themselves mired in convoluted and often contradictory tax, accounting and finance regulations as they try to meet a fundamental cash management goal—optimizing internal money flow on a pan regional basis.

Australia's transaction taxes, for example, affect the way bank accounts are structured and where they are located. India does not allow cross border netting, and South Korea's cash management regulations are very limited as well. Meanwhile, China forbids both cross border netting and domestic currency pooling. China's cash management regulations in fact warrant a separate article.

Pan-regional cash management strategies outside of North America can be very hard to construct, even with the most advanced treasury systems and technology.

Asian foreign exchange restrictions can make it difficult to repatriate profits and in many instances the rules governing financial transactions differ from between regions and even cities.

The main result of this myriad of regulations is that few banks are able to offer pan-Asian banking products and services. Some of the global institutions may offer piecemeal or incremental solutions, but these are far from being fully regional.

The good news is that banks are becoming far more amenable to teaming up with private vendors of global treasury systems to help connect a company's accounts into a central system.

"Our product is a bank agnostic system," says *Dan Gentile*, vice president of business development for ***Clarus***, an e-procurement vendor that recently launched *Clarus Settlement*, a product that allows companies to settle transactions in some 180 currencies across any B2B marketplace.

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Clarus is able to build an adapter for any bank's internal system within three to five days. There are some common standards among banks' payment formats, but "each bank tends to add its own tweak to their system," Gentile says.

Yes, you do need a bank's permission to build an adapter, allows Gentile. However, a client can almost always get it—with a little persuasion, in some cases.

"I have met with some reluctance from banks in the past," Gentile says. "Banks move at their own speed. But the best way to get a bank motivated is by getting the client involved." ❑

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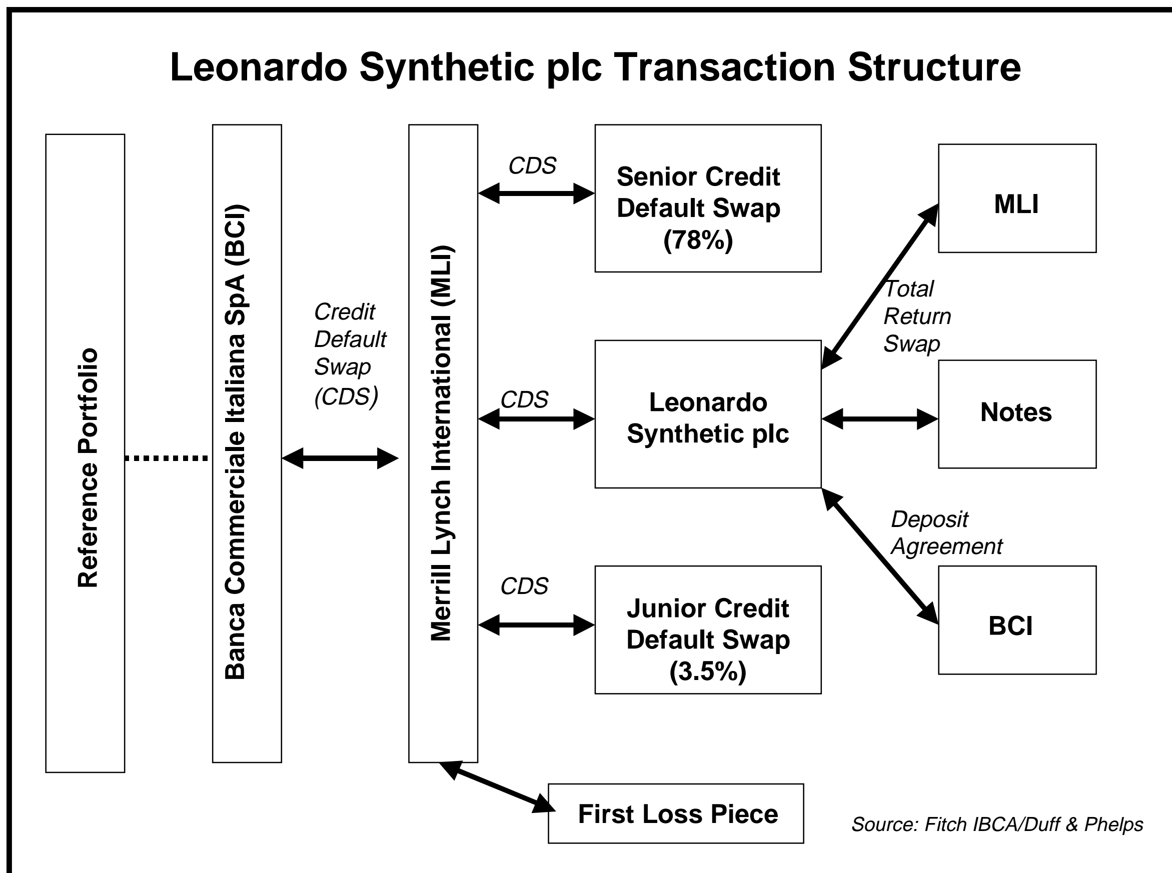
Leonardo, from Page 3



The initial reference portfolio for the swap will consist of loans with a principal amount slightly in excess of $1 billion, skewed toward national flag airlines, such as *British Airways, Alitalia* and *Air France*.

as ***British Airways***, ***Alitalia*** and ***Air France***.

Subject to eligibility criteria, loans can be replaced or substituted for maturing obligations during a "revolving period" that ends in 2005. The agreement between the bank and MLI establishes certain parameters regarding geographic and obligor diversity during that period, in order to avoid excessive accumulations of exposure to particular debtors or regions.

Since the principal amount of the reference portfolio is expressed in dollars and Leonardo's notes and swap are denominated in euros, a fixed exchange rate for the euro-dollar was established as of the closing date.

Since the principal amount of the reference portfolio is expressed in dollars and Leonardo's notes and swap are denominated in euros, a fixed exchange rate for the euro-dollar was established as of the closing date. This arrangement avoids additional risk for investors that might arise from euro-dollar exchange rate fluctuations during the life of the issue.

BCI, as servicer for the transaction, is obligated to ensure a number of requirements are met for each obligation in the reference portfolio, in terms of loan documentation, airworthiness of the aircraft collateral, insurance coverage for collateral, and remaining average life of the reference obligations. These servicing requirements must be met at the time of inclusion of the loan in the reference portfolio, and maintained throughout its tenure in the portfolio.

MLI will enter into three CDS transactions in order to offset its transaction with the bank:

- a senior CDS for a notional amount of $780 million—the counterparty will receive a premium payment from MLI and will pay for credit events when subordinated classes have been exhausted;
- a mezzanine CDS for a notional amount of €172.4 million; and
- a junior CDS for a notional amount of $35 million, which, together with a first loss piece, provide additional credit support and enhancement to the mezzanine and senior CDS.

The mezzanine CDS will be acquired by Leonardo, a bankruptcy-remote SPV incorporated in Ireland. Leonardo, in turn, will hedge its exposure under the swap by issuing three classes of credit-linked notes with a statutory final maturity in 2019, Classes "A" through "C," as follows:

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- Class "A" has a principal amount of €55.6 million and is rated "AAA" by both ***Standard & Poor's*** and ***Fitch IBCA/Duff & Phelps***;
- Class "B" has a principal amount of €83.4 and has been rated "AA" by the agencies; and
- Class "C" has a principal amount of €33.4 and has been rated "A" by the agencies.

Interest on the notes will be paid on a quarterly basis, beginning in June, and will be based on the three-month EURIBOR rate plus a spread that will vary among the three classes.

Leonardo will use proceeds from the sale of Classes "A" and "B" to buy Italian government bonds (IGBs) from BCI. The bonds will have a relatively short remaining life, i.e., not more than ten years, and will be replaced by IGBs of equal quality as they mature. The purchase price stipulated by the transaction for the bonds is equal to 90 percent of their market price, thereby providing a measure of overcollateralization for the benefit of Leonardo's investors.

The IGBs are fixed rate obligations, whereas Leonardo's interest payments to its noteholders are EURIBOR floating rate. In order to hedge this exposure, Leonardo executed a total return swap (TRS) with MLI, which also carries the benefits of the ML guarantee. Under the term of this swap, Leonardo will pay the fixed rate proceeds from its IGB portfolio to MLI and will receive floating rate payments based on EURIBOR.

The total return swap also guarantees that the proceeds received from sale of the IGBs will be sufficient to cover all of Leonardo's obligations under the mezzanine swap agreement with MLI. Investors are thus relieved from concerns about the effect of IGB price fluctuations on the economics of the transaction.

The proceeds of the Class "C" notes are being placed in a euro-denominated cash deposit account with BCI.

A "credit event" occurs upon the bankruptcy or insolvency of a debtor in the reference portfolio, or if such a debtor or its guarantor fails to make a periodic payment of principal and/or interest according to the terms of its loan or lease agreement. These events would require MLI to make payments to BCI, and MLI's swap counterparties, in turn, to make payments to it.

Losses incurred by MLI under its swap with the bank will be first absorbed by the "first loss piece," retained by MLI and by the junior CDS. After that, if a credit event occurs that requires a payout by Leonardo under the terms of the mezzanine swap, the first source of funds will be the balance in the cash account with the bank. If that is totally expended, proceeds from the sale of government bonds will be applied for further payments under the swap. This will have the effect of reducing the principal amount of Leonardo's noted outstanding, beginning with Class "C" and ending with Class "A."

The purchase price stipulated by the transaction (for collateral) is equal to 90 percent of market price, thereby providing a measure of overcollateralization.

In the event Leonardo's resources are exhausted by payouts under the CDS, further losses will be borne by the senior CDS counterparty.

Any of Leonardo's notes that remain outstanding as of June, 2019, will be redeemed at that time. During the life of the transaction, the notes would become subject to mandatory redemption should MLI or BCI decide to terminate their CDS, as a result of any of the following events:

- from 2004 onward, should BCI become subject to a less favorable capital adequacy treatment as a result of the transaction;
- a "clean up call" if the notional amount of the reference portfolio falls below 10 percent of the initial principal balance; and
- if BCI, for any reason, should decide to terminate the transaction on the fifth or twelfth anniversary of the closing date.

Losses incurred by MLI under its swap with the bank will be first absorbed by the "first loss piece," retained by MLI and by the junior credit default swap.

After the fifth anniversary of the transaction, i.e., the end of the revolving period for the reference portfolio, Leonardo's notes would also be subject to partial redemption if the reference portfolio is amortized by more than $780 million (the amount of the senior CDS). ❑

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*The author expresses his gratitude to Mr. Paolo Gribaudi of **Banca Commerciale Italiana**, Milan, for his assistance in compiling this article. I am also indebted to **Standard & Poor's** and **Fitch IBCA/Duff & Phelps** for providing certain additional details and graphics.*

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50 Ways, from Page 9

than market related risks.

Performance Measurement Risk: Any dealer worth hiring can manage his management accounts and will be able to show book-keeping profits at the expense of real losses. Dealing mandates provide only a little more protection than a "comfort blanket." See *Fraud (Staff) Risk*.

Political Risk: What will happen if there is a coup in Indonesia? Will the new government abide by the IMF's terms? Will terrorists bomb your dealing room?

Property (Real Estate) Risk: Do your property asset-backed loans have sufficient cover? Is the property liquid? Also see *Interest Rate Risk*.

Rating Agency Risk: What if the rating agencies downgrade you or your investments? There is evidence that lower-rated bonds default more often than higher rated bonds. Other than the financial market equivalent of a car crash (e.g., ***Barings***), corporate mortality is not instantaneous; it is usually associated with firms in deteriorating stages of morbidity.

"No Risk" is the risk of having a risk manager who always says "No" and who comes up with 50 or so ways not to do the business.

Regulatory Risk: If you operate in several countries you may face inconsistent rules. Some countries insist that branches be ring-fenced for regulatory capital purposes.

Religious Risk: In Islam, is interest *Hallal* or *Haram*? Is usury a problem? This is a particular form of ethical risk. See *Environment Risk* and *Image Risk*.

Resignation Risk: Will the star dealing team move to a competitor after you buy the bank? Maybe there should be football-style transfer fees in dealing rooms?

Settlement Risk: Do you recall, or have you read about, ***Herstatt Bank***? This is the risk that you meet your part of the bargain and your counterparty does not. There are now netting procedures available that will avoid this problem.

Systemic Risk: Financial instability is contagious. Financial systems are closely interlinked. Instability in Indonesia or Korea has a domino effect on markets in Hong Kong, Tokyo and London.

Tax Risk: What did you write on that tax-based savings scheme document? In 1997, substantial losses were suffered by equity index option writers. Changes in the treatment of the tax credit associated with UK shares surprised the market just when margins had narrowed through competition.

Technological Risk: A missing fax was the cause of recent inter-bank dispute. A fax was sent exercising an option, but apparently it was never received by the options desk. Before sending an important fax or e-mail, check the contact data; after sending it, confirm receipt.

Can your systems manage? Can you cope with computer/telephone system failure? Also see *Political Risk*. Establish a second dealing room elsewhere.

Transport Risk: Remember the crash of 1987? That day there was a severe storm in London. Trees were blown onto railway tracks. Many were late for work.

Weather Risk: See *Environment Risk* and *Transport Risk*.

No Risk: In the words of *General George Patton*, "Take calculated risks. That is quite different from being rash." Also recall the credo of ***Fiat***'s *Giovanni Agnelli*, that "It's impossible to take an unnecessary risk, because you only find out whether a risk is unnecessary after you've taken it."

This final risk is arguably the most insidious and dangerous. "No Risk" is the risk of having a risk manager who always says "No" and who comes up with 50 or so ways not to do the business. Of course, you will never appear to lose money. You will never be known for making a wrong decision. It is just that the business will go elsewhere and your firm will find itself with unemployed capital. ❑

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Swaps Safety Net

A series of bilateral currency swaps between Japan and its ASEAN partners are designed to enhance stability of "Tiger" currencies.

Earlier this month, Japan announced that it had concluded bilateral swap agreements with Thailand, South Korea and Malaysia as part of the ASEAN region's continued progress towards strengthened monetary cooperation.

The agreements, which were reached on the first day of the annual conference of the ***Asian Development Bank*** (ADB) in Honolulu, come a year after the 10 ASEAN member countries plus China, Japan and South Korea pledged mutual central bank support at a meeting in Chiang Mai, Thailand.

The swap arrangements were designed to provide former victim states of the 1997 Asian financial crisis with resources to repel any speculative attacks on their currencies. Japan said it was also negotiating central bank swap agreements with the Philippines and China.

Seichiro Murakami, Japan's deputy finance minister, would not disclose the nature or the terms of the swaps agreements except to say they were not based on defense of any pre-agreed exchange rate levels. Most of the region's economies have adopted free floating or "managed float" currency regimes, after speculative attacks obliterated their exchange rate pegs with the dollar in 1997. The bilateral deals provide Korea with $2 billion in possible currency support, with an additional $1 billion for Malaysia and $3 billion for Thailand.

Tun Daim Zainuddin, Malaysia's finance minister, said the agreement, which comes in addition to the $1 billion pledged in mutual swap support by ASEAN countries last November, would help prepare the region for "any eventualities."

"We will not be caught by surprise this time," said Daim. "Our currencies are not at risk now. In fact, in most of the Asian countries, our reserves have increased."

Daim also pointed out that the $1 billion in potential support for Malaysia came in addition to a further $2.5 billion in currency support that had been pledged by Japan under the "Miyazawa Plan," named after Japan's former finance minister.

Unlike the Miyazawa pledge, which comes free of broader conditions, only 10 percent of any bilateral swap agreement can be drawn before triggering control by the ***International Monetary Fund***.

The announcements mark a weakening of Japan's drive towards creation of an Asian Monetary Fund, vetoed by the U.S. in the late l990s. In contrast to Tokyo's original goal of devolving more decisions to Asia, Japan described the bilateral swap agreements as "complementary" to the broader financial framework supervised by the International Monetary Fund in Washington.

The Honolulu agreements, which will be reviewed in three years, form part of a broader drive by ASEAN countries to strengthen regional cooperation following the 1997 crisis. Such efforts, which span deeper trade liberalization within ASEAN and greater political dialogue between ASEAN and its east Asian neighbors, have been given further impetus by the damping effects of the U.S. economic slowdown on the region's high-tech export sector.

Only 10 percent of any bilateral swap agreement can be drawn before triggering control by the *International Monetary Fund*.

Paul O'Neill, U.S. Treasury Secretary, told delegates at the opening ceremony of the ADB annual conference that, in spite of the region's impressive recovery since 1997, Asian countries had to accelerate and deepen efforts to restructure their financial and corporate sectors.

O'Neill's remarks were apparently directed at South Korea, Thailand and Indonesia, which are still struggling to resolve the overhang of bad debts from the 1997 crisis, also urged Japan to take steps to boost aggregate global demand by confronting obstacles to the revival of domestic demand. ❑

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Closer to Agreement about Extent of Credit Derivatives Coverage

A dispute that threatened the credit derivatives industry, an intrinsic factor in development of many structured finance deals, is apparently closer to resolution, although most participants agree there is no easy answer. The "Financial Times" recently reported that the ***International Swaps and Derivatives Association*** (ISDA) is continuing talks with banks and other parties on what negative events should be covered by credit default swaps, contracts that transfer risk from a lender to a third party in return for a premium.

Since the middle of last year, a debate has been raging about whether bank loan restructuring, as well as incidents of default, should trigger a default swap payout.

Loan restructuring has traditionally been covered by the contracts but, last year, several banks in the U.S. market started to exclude them from their standard default swap packages as they fell from favor with third-party investors. Recent high-profile credit events, such as the insurance company ***Conseco***'s debt restructuring and the problems of ***Edison*** and ***PG&E*** in the Californian utility sector, left some investors doubting the value of default swaps.

While, if a default occurs, the bank debt and bonds of a company are usually trading at the same low level, a debt restructuring often leads to the bonds being worth less than bank loans. Investors who had bought credit exposure from the original lender, and had to take on the debts in the event of a default swap being triggered, were unhappy about being burdened with the lowest-value bonds; they stopped buying default swaps covering restructuring.

However, while the U.S. has moved away from offering protection against restructuring as standard, the European and Asian credit derivatives market are sticking with the principle. This divergence goes against ISDA's aim of standardizing the market to speed its continued international growth, best illustrated by the association's 1999 publication of common market definitions.

To some market participants, the best chance of resolving the split is for ISDA to revise its definition of loan restructuring to make it less vague, including specifying what assets will be delivered to the third party on payout.

This would reassure third-party investors that payouts from contracts will be more straightforward and encourage them to offer restructuring protection in default swaps.

"At the end of the day, some modified definition of restructuring will be included by ISDA. It is just a question of what this will be, but the market cannot survive without some resolution," says one default swap trader. "People need to be confident that credit derivatives can cover all credit eventualities, or else why use them?"

A working group of market participants chaired by ISDA met at the start of the month to discuss the latest developments in the debate, and is understood to be considering redefining the guidelines on restructuring.

On-line System Aims to Expedite Exotic Currency Hedging

SuperDerivatives has launched an on-line options pricing system that is intended to ease the job of companies seeking to hedge exposures to exotic currencies.

The "Financial Times" reports that the system provides subscribers with access to accurate, real-time pricing of options, in a manner that was previously only available to the largest, most sophisticated market players.

David Gershon, designer of the pricing system on which SuperDerivatives is based, expects that it will become a benchmark for pricing exotic options.

"The theoretical price produced by existing models often deviates substantially from the actual market price, especially when it comes to exotic options," Gershon explained. "Inability to price an option accurately means that everyone trading exotic currency options is exposed to a massive, unnecessary risk of losing money each time they do a deal. This is far from ideal, given that the purpose of options is primarily to reduce risk."

A senior derivatives trader in the City of London indicated that, while the system would not eliminate the need for companies to consult banks about options, it would allow them to see accurate prices before calling their banks. ❑

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