HORIZON

from

SKADI

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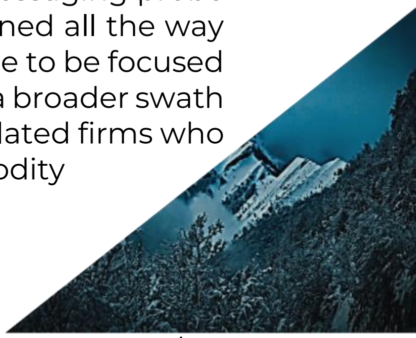
- **Back to the future** - operations staff resort to 1980's processing methods when systems are upended by a cyberattack
- **Record keeping (not the vinyl type!)** - regulators expand WhatsApp messaging probe further into the buy-side – will other firms be next?
- **Forward looking / Spotlight** – marking (or not), pricing, and interest rate hedging

The month in review

Headlines in February detailed the SEC's WhatsApp (and other) messaging probe extending into the buy-side and hedge fund space. As we mentioned all the way back in Horizon Dec 2021, regulators post-pandemic would continue to be focused on record preservation at financial firms, and it is interesting to see a broader swath of non-bank institutions drawn into their orbit. Will other non-regulated firms who use regulated markets to hedge positions (I am thinking of commodity trading houses, shipping firms, mining companies...) be drawn in? As they always say... better safe than sorry!



Bloomberg reported on an incident that took trading back to the 1980's when ION trading UK, a software company that facilitates numerous market participants' securities and derivatives transactions, suffered a cyberattack.

ION's clients reported their struggles to mobilise, with one clearer delaying overnight processing and another taking "alternative measures" to clear trades, prioritising expiring contracts. In contrast to the 1980's, organisations no longer have large teams confirming, processing, and settling trades. Additionally, the article quoted "many of the workers were too young to know how to keep operations afloat". The middle and back-office staff likely hadn't worked in a time when so much manual processing was the norm.

Dave Bridges, SKADI's operations SME, had a similar experience related to this case...

> *"A few years ago, the bank I was working at used ION for multiple pricing tasks. One day, ION wiped an entire day's worth of trading activity and, since it served as our pricing engine, the outage made it extremely challenging to have a clear picture of positions. Manually piecing together two days' worth of trading transactions wasn't limited to settlement - ION fed other trading systems for position, P&L and risk calculations.*

The Bloomberg article mentions staff who resorted to manually inputting individual trades onto exchanges websites. When we consider the number of separate futures fills that feed into systems from gateways such as ICE link, it demonstrates the magnitude of the number of transactions.

Understanding how controls and reconciliations work, where to extract data, where the timestamp and audit trail sit on transactions, knowing which functions are impacted, and keeping communication lines open are vital in these circumstances."

Forward-Looking

An interesting piece in the FT mid-month drew attention to the fact that Insight Investment, one of the UK's largest pension managers, abandoned mark-to-market pricing at the height of the gilts crisis towards the back end of last year. Whilst we are not in a position to comment on whether this was appropriate at the time (am pretty sure FTX would have quite liked that playbook trick) it does once again bring up the marking, pricing and hedging of books. In fact, as we go to press, headlines across the world are shining a spotlight on what went wrong at Silicon Valley Bank (SVB).

Although SVB seems to be no more than an old-fashioned bank run, one of the underlying issues is that they held Level 1 and Level 2 assets as part of regulatory HQLA (High Quality Liquid Assets) requirements but did not appear to hedge out the interest rate risk (usually done via swaps). As SKADI MD Nic Corry wrote about presciently back in Horizon's October 2022 edition, interest rate risk, or Rho, may have been overlooked in the previous low-rate environment, and could now come back with a vengeance.

We would recommend control functions take a close look at any products with embedded interest rate risk and, indeed, any products where accounting practices might allow a product to be marked at cost rather than at market (SVB continued to mark its bond positions this way, it was only the selling of some of the securities at market that crystallised the loss). It is only when stresses appear in the market (are we about to see a lot of these post SVB?!?) that marking and hedging (or lack of it) come to the fore.

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