HORIZON
from
SKADI

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with special contribution from **Juan Corbella**

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In this month's HORIZON:

- **Winds of change -** politics is on the move. What does this mean for Markets, Culture and Control…?

Introduction

Readers of our "SKADI Emerging Risks - 2024 Outlook" will recall we cited **elections** as one of our key drivers which would dominate the stage in 2024. As we go to press, voters in the UK head to the polls, followed by voters across the Channel in France, reacting to a snap election called to challenge a swing to the right. Meanwhile, months out, the US election is already influencing capital flows, as investors digest President Biden's performance from the first televised debate.

Whilst the election in the UK seems set to be the most predictable in recent history. The outcomes of elections in France and the US will only be revealed with the passage of time. Those outcomes are likely to have significant impacts on the direction of policy, spending, inflation and as a consequence interest rates, capital flows and volatility.

For those in control within finance, particularly **Compliance** and Compliance Advisory, the watch-word since Brexit has been divergence. Climate, and Environment has driven a sea change in Risk Management and Lending. It is possible, even probable, that these are about to change...

Volatility

Elections tend to increase **volatility**. We have seen this so far this year with South Africa (big JSE rally), Mexico (weak Peso) and also in India (NIFTY fell 9% in 2 days, before recovering).

With two main gauges of volatility, the VIX (equity vol) and the MOVE Index (bond vol) at or around their lows, it could be that markets are evidencing complacency, especially with November's US election still to come. Volatility is a significant component of many products structured and sold to **retail investors** and private wealth clients. If we think in equity terms, holders of a number of yield-enhancing products (for example autocallable structures that we have written and talked about at length before) are implicitly short volatility. The same is true in the FX market - Juan Corbella writes in more detail on this below.

Swing to the Right – ESG implications

Whilst this piece is written before the result of the second round of French elections are known, there is no doubt that there has been a move to the right across a number of EU countries. This could have implications for attitudes towards Climate Risk and Climate Finance. As we wrote about with regards to Emissions Risk Transfers in March 2024 and Green Mortgages in May 2024, there has been a huge regulatory-led push for **capital-relief** on products that help finance pro-green and pro-energy transition projects. Despite this, there exists the possibility for relaxing of political attitudes, along with commitments to zero carbon targets.

Taxes to come

We discussed tax risk way back in Horizon in July 2022. From a UK-specific point of view, all of the main parties have been uniformly quiet on the funding of various election promises. Whilst the likely outcome is a change from a Conservative to Labour government, we expect the incoming Labour government to attempt to reassure business and industry in Britain. However, the need to increase **tax receipts** will be firmly on the agenda in the years to come. Labour have already made noises regarding Private Equity carried interest, and we are sure there are other financial products which will attract scrutiny. As we said back in 2022…

"*…tax issues should be front and centre of control functions priorities, and any tax efficient products that were structured in recent years should be checked to make sure that documentation is watertight*".

Issues for control functions

For control staff at Wholesale Financial firms, we feel the following areas should be considered:

- Modelling and Quants – what volatility assumptions are used by the front office when pricing certain products? What is the look-back time period for volatility? What stress-tests are carried out looking at previous high volatility environments?
- Consumer Duty/Suitability – It may be prudent to conduct assurance reviews now to verify that products have been correctly assessed for suitability. That marketing has been clear and that potential risks have been explained.
- Mark to market procedures – what procedures are in place for marking products with low trading volume / low-transparency pricing?
- Tax risks – to reiterate above – ensure documentation around any tax efficient products that were structured in recent years is checked to make sure that it is watertight

Spotlight on FX & Political Risk – Juan Corbella (Foreign Exchange lead)

The price for converting funds from one currency into a different currency is simply the point where the demand of the currency you are selling matches the supply of the currency you are intending to purchase. This equilibrium point is called the spot price. This spot price adjusts to reflect any change in either of the two underlying countries net flows.

It would be an impossible task to calculate the net aggregate flows for any country and, by definition, FX trading requires the information for two different countries. Furthermore, the spot price available now includes the expectations of future change in flows – making it even more difficult to predict these flows or spot price future trajectory.

The calendar for the rest of the year includes several major economies elections (France, UK, USA) and the inauguration of recent winners (Mexico, EU Parliament, South Africa). No question each of these changes will be preceded by rumours, changes of policy, possibly drastic changes in leadership, implicating new set of government targets and policies. We could expect large international investment flow withdrawals as part of a risk reduction policy. Depending on the election results these flows could be reverted or possibly channelled to other economies with better growth outlook. This year trade protection barriers have attracted voters. We should expect further imposition of trade protection measures ringfencing their domestic industry. Pressure on central banks to ensure stronger growth. Spot volatility is likely to escalate higher or remain at these levels. I very much doubt we are about to enter ranging spot markets in a low volatility environment.

Areas of Risk

During high volatility periods, ensuring all confirmations have been matched will prevent non-detected trading errors. Possible outstanding disputes must be resolved immediately, or at least the market risk needs to be closed.

Market Orders should be reviewed to confirm their validity and are properly recorded. Customers with stop-loss market orders should expect possible larger price slippage. Political news can hit the market at any time, even when the liquidity is at its worse or during a weekend's market close causing a price gap jump when the markets reopen. It is good to remind traders of their overnight market exposure limits, stop-loss rules, and which currency pairs are included in their mandates. External customers are always relevant, but don't forget other internal product trades or department dealing internationally and exposed to FX risk.

One of the main contributors of FX volatility is interest rate differential. Central Banks use higher short-term interest rates, making it more expensive for market participants to reduce their currency exposure. Central Banks and expect their currency to stabilise when speculative positions having been closed.

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Damian, Nic and Juan's expand on these topics on this month's Horizon Unpacked podcast. Listen here:

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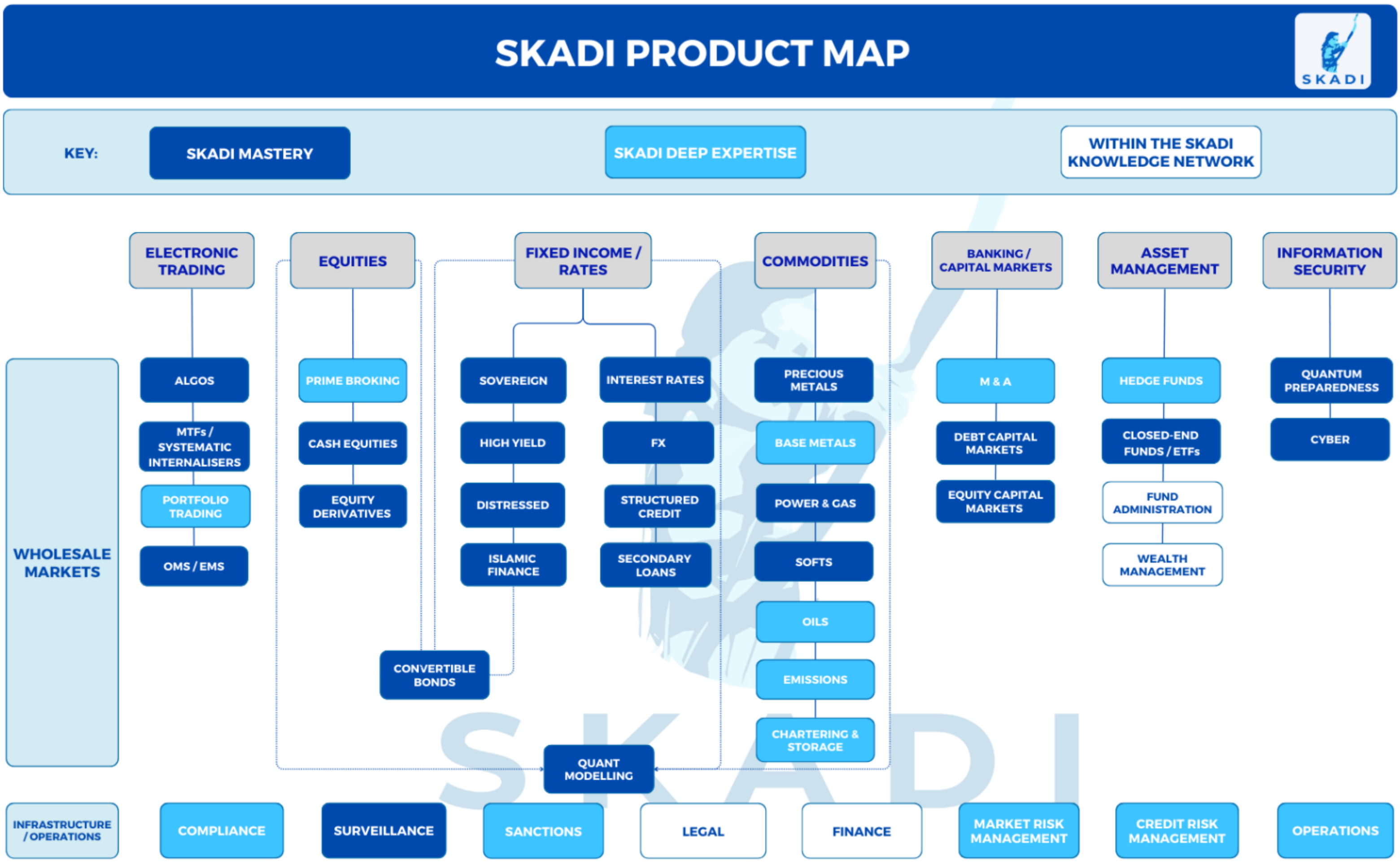
Previous Episodes List:

36. Horizon Unpacked May 2024: Green Mortgages
35. Frasers Group vs Morgan Stanley revisited with Robin Henry from Collyer Bristow
34. Horizon Unpacked April 2024: Rogue (Delta) One and Revenue before Controls
33. Structured Credit Disputes with guest Robin Henry
32. Horizon Unpacked March 2024: Emissions Risk Transfers and EU Emission Trading
31. Career Change Chronicles: Damian Taylor
30. Horizon Unpacked February 2024: CLOs, CRE and Culture Risk
29. Frasers Group vs Morgan Stanley
28. Horizon Unpacked January 2024: Autocallables and Quantum
27. Career Change Chronicles: Niral Kalaria, CFA
26. Horizon Unpacked December 2023: Scrivener's errors and Fund liquidity mismatches
25. Horizon Unpacked November 2023: Problematic Convertible Bond Structures and T+1
24. Horizon Unpacked October 2023: Binaries, Digitals, CDS and Stock Loan
23. Harnessing Investigations to drive Organisational Transformation with Niral Kalaria
22. The Greek Crisis part 3
21. The Greek Crisis part 2
20. The Greek Crisis part 1



"Whether we've worked as traders or in operations everyone you'll speak to at SKADI has front-line knowledge and a deep understanding of financial products"

Previous **Horizon** s can be found [here]

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