HORIZON
from
SKADI

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- **The fallout from the gilt sell-off continues.** We look at how manual processes can cause bottlenecks within financial institutions.

- **Year-end marking.** How will private markets be marked to reflect the public markets sell-off.

- **In this month's SKADI Spotlight – Uridashi Bonds.** In a new explainer feature, we look at Japanese Uridashi bonds.

The month in review

With the "transitory" inflation argument seemingly dead and buried, market participants have now turned to "looking through" the current data to attempt to predict when the Fed will ease off its current tightening cycle. Back-to-back +5% months for the S&P may have left market observers scratching their heads, but you wouldn't bet against another one in December just to rub salt into the wounds of all those who upped their cash component earlier in the year.

In SKADI-world (is that Asgaard? – Ed), headlines in November's Sammendrag included reports of a global custodian becoming "overwhelmed" processing their clients' margin calls. UK regulators are now calling on custodians to improve their manual processes.

As SKADI's operational SME Dave Bridges explains:

"*For manual payment processing, an instruction will need preparation which will then be checked and subsequently approved by at least two authorised signatories. The payment will then require input and verification into SWIFT by two separate users. Once released from SWIFT, the message may be subject to review against sanctions screening requiring validation before being paid.*

When the rapid drop in Gilt prices caused an unexpected ramp-up of manual payment handling needing to pass through layers of essential controls, even with the best intentions there are a finite number of transactions that can be actioned before missing payment cut-offs.

Additionally, some less obvious but important challenges surface when overreliance is placed on manual instructions when a huge volume spikes: is the list of authorised signatories with sufficient clearance up-to-date? With access to SWIFT highly restricted, are sufficient users set up with access?"

Forward-Looking

Parent-Subsidiary accounting thoughts

In light of various headlines from the Bank of Spain urging lenders to preserve capital as risks increase, we thought it an opportune moment to look at how governments taking actions domestically to protect mortgage holders could have knock-on effects. A similar issue played out after the GFC in 2008. Given many banks have a supra-national reach, changes in tax or accounting treatment in a subsidiary jurisdiction may not be fully recognised at Group level and we would advise keep a close eye on this. Spain is an interesting case given the number of institutions that have made a move towards Spain post-Brexit.

Marking into year end.

With the increased volatility we have seen in 2022 and numerous write-downs in the public markets, especially in the tech (and dare I say, crypto) sectors, it will be interesting to see how the year-end develops regarding the marking of private sector (private equity etc..) holdings. We have seen the first wobble in the case of the Blackstone Real Estate Income Trust (BREIT), and rumblings around a small niche area of the PE market known as Collateralised Fund Obligations (CFOs). Once again (isn't it ever thus) the key to markets is liquidity and we would urge control functions to keep a very close eye on the marking of illiquid assets and, more importantly, the assumptions and variables used in mathematical models used to value Level 3 assets. Many models use realised or anticipated interest rates and/or inflation rates in their inputs and documenting how and why these have been obtained will be crucial.

SKADI Spotlight: Uridashi Bonds

Uridashi bonds were introduced as a way of enabling Japanese retail investors to source yield during Japan's sustained period of ultra-low interest rates. The bonds transfer high yields from foreign assets to retail Japanese investors. The key risk is that the currency risks are not hedged. This has resulted in catastrophic periods where investors have found their capital denuded by foreign exchange fluctuations.

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