

Enterprise Governance; WaMu Self-Inflicted Wounds, Energy Sector: New Life; Hedge Funds and Energy Trading

Enterprise Governance: Redressing the Balance

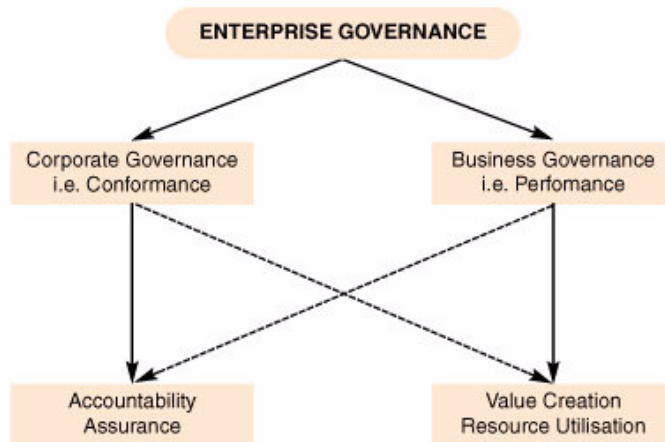
*Contributed by Kingston Ho
PRMIA Member Since March 2002
Regional Director, PRMIA Hong Kong*

Recent corporate failures such as Enron and Worldcom have sent major shockwaves round global capital markets and investor confidence in the market system has been severely dented. The credibility of financial reporting and corporate disclosure has been impaired. This can have serious consequences in the form of a higher cost of capital and in turn, reduced economic productivity. It is not surprising, therefore, that corporate governance reform has been at the top of the agenda in many countries.

However, there is a danger that in the vital and necessary attempt to improve standards of corporate governance, insufficient attention is paid to the need for companies to create wealth and to ensure that they are pursuing the right strategies to achieve this. After all, there are many examples of company difficulties where the failure was one of strategy rather than of corporate governance. The impact in terms of reduced investor confidence and lost jobs is just as devastating.

The framework of enterprise governance with its focus on both the corporate governance and

the business management aspects of the organisation can help companies to strike the right balance between conformance and performance. At the heart of enterprise governance is the argument that while bad corporate governance can destroy a company, good corporate governance on its own cannot make a company successful. It is essential to focus not just on what goes wrong, but on how companies can help to ensure that things will go right ... and that means looking at strategy and performance.



need assurance that the board is spending sufficient time and effort on understanding the strategic environment, ensuring that all the strategic options and risks have been explored sufficiently and monitoring implementation. In other words, good enterprise governance is about balancing the conformance or historic view of the business and the performance or forward-looking aspects of the business.

Good enterprise governance will mean that investors' interests are both protected and enhanced in the long term. For leading financial centres that are serious in maintaining and furthering their competitive edge this emerging concept should be of particular relevance and interest. The future **(Continued on Page 2)**

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Points of Interest

- Membership Up 130% in Fiscal Year Ended June 30, 2004
- Barra and Algorithmics Renew Sponsorship of PRMIA
- PRMIA C-Suite is an invitation-only network for senior officers in risk and finance. Recommend your senior officers to csuite@prima.org.

WaMu: Self-Inflicted Wounds, Is it the People or the Business Model?

(Continued from Page 1) prosperity of financial centres such as Hong Kong and New York do require sound and stable capital markets based on a high level of investor confidence. Enterprise governance could be the way forward.

The Professional Accountants in Business Committee of the International Federation of the Accountants (IFAC) has undertaken a project to develop and explore the emerging concept of enterprise governance. It has published a report in 2004 which can be found in <http://www.cimaglobal.com/main/resources/developments/enterprise/>.

Wa-Mu Self-Inflicted Wounds

Contributed by Christopher Whalen
PRMIA Member Since January 2004
<http://institutionalriskanalytics.com/index.html>

Watching the negative press heaped upon Washington Mutual (NYSE:WM) makes us wonder, is it the people or the business model? WM's team was once the toast of Wall Street -- at least until the bad news started to flow. Now they seem to be just toast.

One Sell Side analyst calls the problems "self-inflicted wounds," an amazing description for a bank that was once seen as a source of new ideas in a staid and shrinking industry. The \$248 billion asset WM was the new, retail driven bank of the future, an acquisitive, branch-sprouting juggernaut that was going to show the other Mega Banks how it was done. No more.

When WM Chief Executive Kerry Killinger said the effects of interest-rate changes "are likely to outpace the timing of ongoing cost-reduction plans in our mortgage banking business," we almost heaved our Wheaties. Not, mind you, because we were

surprised to hear his particular revelations about poor interest rate risk management, but for what this confession implies for the rest of the industry.

We have ranted several times in the past month about the "[Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities](#)," a effort by the OCC, OTS, Federal Reserve, FDIC and SEC to improve compliance and oversight over derivatives and other "complex" but notional financial instruments.

Part of the reason for the sudden interest in this subject by regulators, we're told, is the mounting evidence that banks -- even large banks, have not a clue what they are doing when it comes to even the most basic types of risk management. As we asked not long ago and we'll repeat, if giant organizations the likes of WM or Fannie Mae (NYSE:FNM) cannot manage the duration risk of relatively pedestrian mortgage portfolios, what makes the regulators think that the vast majority of smaller institutions can play in the world of customized derivatives?

The other scary aspect of the WM debacle is how the bank's heretofore solid image with the Sell Side barely hinted at the problems now revealed by the change in earnings guidance. Below the surface, however, the key ratios are remarkable -- and have been visible to fundamental analysts for a long time.

The historical loss given default rate for WM's lead bank had largely tracked the mortgage lending specialization peer group defined by the FDIC, but the degree of interest rate sensitivity of its liabilities is well above the peer mean, while the rate sensitivity of its assets is well below that of other mortgage lenders, according to Q1 2004 data from the FDIC. In keeping with its aggressive image, WM's loans as percent of assets is 10 points above the peer mean. On the liability side, WM's deposits to assets ratio is 57% **(Continued on Page 4)**

Over 330 Jobs Posted On the PRMIA Jobs Board: 124 New This Month

The PRMIA Jobs Board is a free resource to PRMIA members. Over 25,000 job searches take place each month on the board and this month, over 330 Jobs in fourteen countries are listed.

Risk Management Project Manager

Fifth/Third Bank

Cincinnati, OH, US

Senior Director of Sales—OpVantage

Salary: US\$Competitive

New York, NY, US

If you're looking to hire, you can post your openings for free and can even use the search utility to find a certified PRM to meet your needs.

Director of Risk

Salary: US\$120,000

Moscow, RU

Each month we randomly feature some of the latest postings, but be sure to search the entire database to see what is available. All job listings can be found at www.prmia.org/jobs/jobs.html.



Other PRMIA News and Items of Interest

PRM Handbook Launched — Available Online

With the outstanding editorial work of Prof. Carol Alexander, Chair of the Risk Management department at the ISMA Centre, University of Reading, and Prof. Elizabeth Sheedy, Associate Professor at the Macquarie Applied Finance Centre in Sydney, the PRM Handbook has come to life on the PRMIA website.

With contributions from over 35 leading authors on risk management, finance, financial markets and mathematics, the PRM Handbook is both the preparatory guide for candidates in the PRM certification program and the top reference source available on financial risk management.

Because PRMIA's membership is so broadly dispersed, and our mission calls on us to serve emerging as well as developed markets, the PRM Handbook is delivered in electronic format, anywhere in the world that an internet connection exists. It is the only such comprehensive text on risk management available so broadly, making it an instant international standard. The PRM Handbook is available exclusively to PRMIA members at http://www.prmia.org/PRM_Handbook/handbook_intro.php.

Kingston Ho Named New RD for Hong Kong

The Professional Risk Managers' International Association (PRMIA) is pleased to announce that Kingston Ho has been named the new Regional Director for PRMIA Hong Kong, the 5th largest chapter in the PRMIA network.

Kingston Ho currently serves as Senior Manager, Wholesale Bank Business Finance, of Standard Chartered Bank (Hong Kong) Limited. From 2002-2004, he served as the Head of Fixed Income Operations, Crédit Agricole Indosuez, Hong Kong Branch and has held positions with DBS Bank (Hong Kong) Limited, UBS Hong Kong, Bankers Trust London, and JP Morgan London.

Mr. Ho is a certified Professional Risk Manager (PRM), a Certified Risk Planner, a Registered Financial Planner, a Fellow of the Chartered Institute of Management Accountants, UK, and a member of the British Computer Society.

"We are indebted to James Tunkey for his leadership in establishing PRMIA Hong Kong and his work with the local Steering Committee to ensure continued

vibrancy," said David R. Koenig, PRMIA's Executive Director and Chair of the Board. "Kingston served on that Steering Committee and received their full support to continue the work forward. We are very lucky to have him involved and look forward to continued growth and service from PRMIA Hong Kong."



Top Scores in Second Quarter 2004

Exam I - Finance Theory, Financial Instruments and Markets

Dominik Dersch, Munich, Germany

Exam II - Mathematical Foundations of Risk Measurement

Dave Tianqi Fang, Charlotte, NC, US

Exam III - Financial Risk Management Practices

Frank Bensics, New Britain, CT, US
Stephan von Bismarck, London, UK



Congratulations to the Top PRM Candidates

Exam IV - Case Studies, Standards of Best Practice, Conduct and Ethics, PRMIA Governance

Chandramohan Ganapathi, Kuwait
Anthony Okuefuna, Glasgow, Scotland

Life in Merchant Energy Sector; Hedge Funds Filling the Void

(Continued from Page 2) compared to 76% for the mortgage lending peer group. In terms of Op-Risk, WM's Other Liabilities category is a whopping 23% of total assets vs. 10% for the peer group.

As we learn more details regarding WM's internal difficulties, risk managers should consider whether the price-based metrics that Wall Street relies upon for predicting default and restate-ment risk served their stated purpose in this case. WM's stock price traded above \$46 per share in November 2003, then fell back to \$40 before year-end. The valuation then rebounded above \$45 in Q1 2004, but is now near the 52-week low. Q: Given that the profile in the paragraph above was clearly visible in WM's historical financial statements, why would any investor (as opposed to a momentum driven punter) who favors bank paper ever like this name?

The answer, it seems to us, is that WM has consistently reported asset returns roughly 2X the mortgage lending peer mean, albeit returns built upon a structure that is far more aggressive than the mean. This suggests that in the future, those institutions that evidence above-average performance with a risk profile that is also significantly higher than the peer group should be chal-lenged to verify those results.

The Vaunted Notion that the Merchant En-ergy Sector is Dead is a Bit Overstated

Contributed by John Sodergreen

PRMIA Member Since February 2002

<http://www.scudderpublishing.com/>

“The Vaunted Notion That the Merchant Energy Sector is Dead is a Bit Overstated,” says Marcella Donadio, the co-head of Ernst & Young’s Energy Trading and Risk Management Prac-tice. “To a large degree, the [asset-lite] model has changed, mainly due to the new regulatory and corporate governance en-vironment. But what we’re seeing emerge, significantly, is a new model, a model where these merchant companies are step- ping into the void to provide pure risk-management services.”

Donadio says that, from the perspective of the third party ser- vices provider, helping end-users to manage price volatility is a huge opportunity these days – and will continue to be well into the future. This is good news for the recovering merchant sector and for market liquidity in general.

Donadio’s practice advises merchants and others on setting up the necessary infrastructure (“people, processes and technol- ogy”) to meet this new market demand for sophisticated risk- management services.

Back in the merchant heyday, the likes of Mirant and EP, Enron and the rest made pretty good book selling these outsourced risk

services, helping contracts negotiations, securing power supply, fuel and so on. When the market dropped, all these services quickly went away.

“Together with the closing of the proprietary trading, all of these desks that were dedicated to supporting major commercial end- users, the upstream segment of the industry and so on fell into this big void. Well, the big trend now is to fill that void.”

Donadio tells us of a customer that, up until a short time ago, focused on a very narrow band of the industry. “They recently expanded their activities to do a tremendous amount of trading in the natural gas segment. Their book of business in natural gas is bigger than it’s ever been. We’re seeing a lot of this kind of activity. So when we come in, we try to help these companies with their risk-management infrastructure issues from two per- spectives: first, to establish the right controls around people/ process/technologies; and second, to make sure the risks traders are taking are in sync with corporate goals and objectives.”

Hedge Funds: the Next Wave in Energy Trading

Contributed by Peter Fusaro

PRMIA Member Since June 2004

<http://www.global-change.com>

Speculative energy trading has a strong future, but it will not be the traditional utilities and energy merchants that will create and mature that market. While much of the energy industry has returned to the relative safety of trading around assets and mar- keting activities, energy markets have become characterized across all energy commodities by increasing prices and price volatilities. Oil markets are booming and were not at all im- pacted by the Enron collapse. As a result of geopolitical issues, the relative weakness of the US dollar, and other supply/demand factors, higher prices are sustainable with increased price vol- atilities set to be the norm. The future for North American natu- ral gas is similar as supply and production declines have also resulted in higher sustainable prices and increased price volatil- ities. Electric power continues to exhibit tremendous price vola- tility.

It is a combination of this price volatility and available energy trading talent that creates the opportunity for hedge funds. With over 100 hedge funds already playing or set to play in energy commodities, they are primed to bring more **risk capital** to energy markets. They also bring sophistication, li- quidity, the risk culture and trading acumen to bear on energy markets and have access to readily available experienced trading resources. While new hedge funds are being created specifically for the energy trading opportunity, existing larger hedge funds are also planning to enter energy markets.

(Continued on Page 5)

Hedge Funds Filling the Void in Energy Trading Markets

(Continued from Page 4)

Energy is a \$2 trillion commodity market and a \$4 trillion physical market, dwarfed by foreign exchange and interest rate derivatives trading. However, commodities usually trade 6 to 20 times the physical market and so energy is a long way from market maturation. Thus, energy markets are ripe for further commoditization and are just getting started with global oil markets predominating. Energy trading will now be dominated by more sophisticated and well-capitalized financial players such as hedge funds and investment banks, as well as by multinational energy companies with a global footprint, while electric utilities are more marginalized to niche markets. Evidence of the fund's influence on oil markets has been the 55% growth in open interest on Nymex crude, heating oil and gasoline contracts over last year and the more violent and volatile intraday trading moving during recent months. These market drivers are bringing greater financialization and maturation to the energy complex.

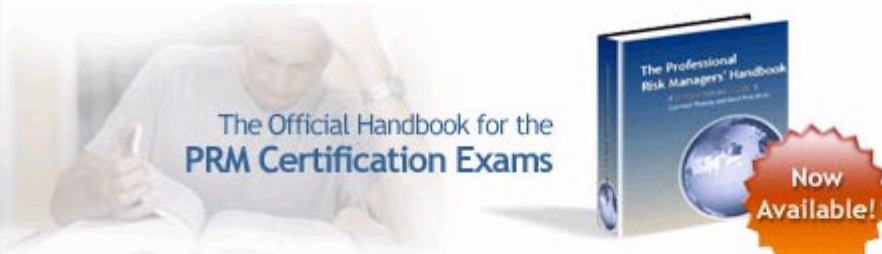
The speculative trading model that will emerge in the hands of

much more sophisticated, well-capitalized players including hedge funds and investment banks is about to unfold. There is a two-tiered market emerging with existing hedge funds attracted by the volatility in oil, natural gas and coal markets and hiring seasoned energy traders and new hedge funds are being created specifically to trade in energy markets.

Peter Fusaro is Chairman of Global Change Associates, an energy risk management consultancy based in New York. He is authoring a multi-client study on the Hedge Funds entry in to energy trading markets. Further information on the study may be obtained at peterfusaro@global-change.com.

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**The Professional Risk Managers' Handbook:
A Comprehensive Guide to Current Theory and Best Practices**
Edited by: Prof. Carol Alexander and Prof. Elizabeth Sheedy



The Official Handbook for the
PRM Certification Exams

Now Available!

Edited by [Carol Alexander](#) and [Elizabeth Sheedy](#) and with in-depth contributions from over [35 leading risk and finance practitioners and academics](#) from around the world, The **Professional Risk Managers' Handbook** is the official study manual for the PRM certification exams. The Handbook has been written to cover the PRM syllabus in a comprehensive and practical manner, offering students the very best study materials available. Each chapter tackles the theory and practice of risk management and includes a wealth of case studies, practical information and worked examples.

The PRM Handbook is also an invaluable learning tool for professionals interested in keeping abreast of best practice risk management and the latest industry thinking.

PRMIA

PRM HANDBOOK FEES

	Per chapter	Per section *	Complete Handbook
Registered exam candidates	\$ 15	\$ 95	\$ 150
Other PRMIA members	\$ 25	\$ 150	\$ 250

Regional Chapter Profile: PRMIA Toronto

Statistics

Membership: 1,382

Chapter Formed: April, 2002

Members' Areas of Interest:

- 41.1% Credit Risk
- 39.1% Derivatives
- 33.5% VaR
- 33.1% Financial Engineering
- 33.1% Financial Risk
- 29.5% Asset/Liability Management
- 29.2% RAROC /RAPM
- 29.0% Traditional Asset Management
- 29.0% Fixed Income
- 28.9% Trading / Capital Markets

Regional Director

Dan Rosen, Algorithmics

Steering Committee

Luis Seco, University of Toronto

Alexander Shipilov, PricewaterhouseCoopers

Recent Events

Rating System Dynamics and Bank-Reported Default Probabilities under the New Basel Capital Accord by Erik A. Heitfield, Federal Reserve Board



PRMIA Toronto
Regional Director,
Dan Rosen

Implementing Pillar 2 and the Role of Economic Capital Models by Mr. Lorey Arthur Hoffman is currently Senior Director at the Office of the Superintendent of Financial Institutions, Canada ("OSFI").

PRMIA Toronto events are held in partnership with the Fields Institute at the University of Toronto. We are very grateful for their support.

PRMIA has local chapters in over 50 regions of the world and more on the way (★). These chapters host local meetings for those interested in the advancement of the risk management profession and are at the heart of the PRMIA Mission

