Antonio Polverino, JP Morgan Chase

L'Espresso loses out in interest rate trade

Gruppo Editoriale L'Espresso, the Rome-based media company that publishes the Italian broadsheet *La Repubblica*, has lost €15.87 million as the result of trades in interest rate derivatives. *Risk* understands that a substantial part of that loss was attributable to an exotic product sold to the company by JP Morgan Chase.

While neither company will comment on this specific transaction, both L'Espresso and JP Morgan Chase acknowledge they have dealt in derivatives together, as part of a long-standing advisory relationship. The mark-to-market loss, which occurred when US dollar swap rates jumped over 100 basis points in July, was followed by the abrupt resignation of L'Espresso's chief financial officer, Raffaele Vanni.

A medium-sized Italian company mostly owned by the De Benedetti family, L'Espresso has stated in its financial accounts its policy of swapping its fixed rate bonds into "a range of floating rate exposures" with the help of "a major investment bank". The purpose of the swaps was "to hedge against risk exposures on the bond issue", according to the company. Market sources say the exotic derivatives component of these swaps increased sharply during the first half of 2003 and L'Espresso's half-yearly interim results refer to 'financial operations on interest rates made in the second quarter of the year'. According to sources at several Italian companies, this was at a time when several international investment banks, including JP Morgan Chase, were making a marketing push focusing on products with US dollar exposure.

The salesmen who approached these companies pointed to the low level of short-dated US dollar interest rates, then hovering around the 1% mark. A company – such as L'Espresso – that had swapped fixed rate euro-denominated debt into floating euros would be paying up to 150 basis points more. Why not enter a differential or quanto swap, suggested the salesmen, receiving a fixed dollar rate and paying floating dollar Libor, with the payments expressed in euros. More exotic variants were also suggested, involving the client selling a barrier option with a dollar swap rate trigger. The salesmen also proposed the selling of US dollar swaptions.

The questions being asked about L'Espresso's losses are, first, how much the company's board knew about its finance department's dealings with JP Morgan Chase and, second, whether the company, which has negligible US dollar revenues and zero US dollar debt, was buying a financial derivatives product that was unsuitable for its own purposes as well as risky.There is no law to stop Italian companies buying exotic products of the type purchased by L'Espresso, and neither is there such a law in the United States, for example. However, US accounting standards require companies to mark their hedges to market and disclose their value in their financial accounts.

In Italy, long regarded as a hotbed of financial innovation, a number of corporate treasurers and financial officers have been keen to initiate leveraged bets using exotic derivatives. And some of those bets have paid off. For example, one leading media company, which asked not to be named, said that in 2002 it had transacted a €25 million euro-dollar Libor-in-arrears quanto swap with Deutsche Bank, and had closed out the trade at a profit.

A number of Italian companies have been keen to initiate leveraged bets using exotic derivatives

However, a number of Italian companies have been turning away from similar, complex, deals. Since 1999, the Rome-based energy company Enel has publicly adopted a 'vanilla only' policy in using hedging instruments. Before 1999, Enel was well-known as an adventurous user of derivatives. Despite Enel's change in policy, it was offered exotic derivatives products by JP Morgan Chase at around the same time earlier this year as L'Espresso. A source at Enel says that although JP Morgan Chase's head of corporate derivatives marketing for southern Europe, Antonio Polverino, was a "good salesman", Polverino failed to persuade Enel to change its policy of only using vanilla products. Enel says it continues to enjoy a "positive" relationship with JP Morgan Chase. Polverino is responsible for a number of marketing and sales staff dealing with Italian companies, according to JP Morgan Chase, although it is not known whether Polverino dealt directly with L'Espresso.

Unlike Enel, Rome-based telecommunications company Wind does use euro-linked exotics including barrier and trigger swaps, but largely shuns any foreign currency exposure. According to Roberto Bruschi at Wind treasury, the company devises its hedging strategy internally and uses JP Morgan Chase on a purely execution basis. "We have not made use of the particular skills of Antonio [Polverino]," he says. Wind has not transacted any derivatives deals with JP Morgan Chase in 2003 because it has reached a credit limit with the bank, said Bruschi.

One company that does use JP Morgan Chase for hedging its interest rate and currency risks is Milan-based publisher Mondadori. According to Steve Raffin, a risk manager in the firm's finance group, Polverino made a lengthy sales pitch for the dollar-euro quanto swap product early in 2003, highlighting the dollar-euro interest rate differential. In a JP Morgan Chase pitch document seen by *Risk*, the bank deployed a liability diversification argument with an efficient frontier analysis in its attempts to persuade mid-sized Italian clients to take on quanto dollar exposure. However, on this occasion, Raffin and his colleagues decided that the risks were unacceptable, and declined the trade.

But Gruppo Editoriale L'Espresso was a more receptive client. No stranger to derivatives, L'Espresso has used paper swaps to hedge the cost of newsprint since 2000 and in 2001 experienced a default by Enron on its paper contracts. The relationship between L'Espresso and JP Morgan Chase dates back at least to August 2000, when Chase Manhattan and Banca Commerciale Italiana acted as joint bookrunners on the company's €200 million five-year bond issue. Since then the company has regularly cited the use of interest rate swaps in

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its annual reports as a factor in reducing interest expense. For example, at the end of 2002, the ratio of financial charges to total debt (net of cash reserves and marketable securities) suggests an average interest expense of 3.9%, considerably less than the 6.5% coupon on the bonds.

In 2003, L'Espresso's hitherto successful hedging strategy would go badly wrong. It appears that L'Espresso's Vanni entered into a leveraged swap transaction with JP Morgan Chase in the second quarter of this year; a deal apparently linked to its entire €200 million of outstanding debt. L'Espresso will only say that *Risk* magazine's "reconstruction of the facts … is in part inaccurate".

It is not clear exactly what product was sold to L'Espresso. Some sources in the Italian market say it was a dollar-euro quanto swap. A JP Morgan Chase spokesman suggests that some sort of long duration, short gamma option position was involved.

Whatever the details of the transaction, it was struck by disaster in July 2003 when, in the space of a few weeks, the five-year dollar swap rate increased by 120 basis points, and implied volatility increased too. This apparently resulted in a rapid mark-to-market decline in the value of the swap. As an unrated company, L'Espresso would have been subject to a collateral agreement with JP Morgan Chase. Towards the end of July, with the swap heavily underwater, JP Morgan Chase is understood to have made a margin call on L'Espresso.

In 2003, L'Espresso's hitherto successful hedging strategy would go badly wrong

Exposure

During the week of July 21, Vanni broke the bad news to L'Espresso's board. His deal had exposed the company to the largest US bond sell-off for 10 years. For a company that hedged euro fixed-rate bonds with vanilla euro swaps, the mark-to-market hedge loss after an equivalent move in euro swap rates would have been matched by a decline in the price of its bonds, offering a buyback opportunity. But with a quanto product there is no such natural offset. According to sources, discussions ensued between the L'Espresso board and JP Morgan Chase. An agreement was reached to limit the payment made by L'Espresso to JP Morgan Chase to an amount significantly lower than the initial margin call. On July 24 Vanni resigned. L'Espresso is understood to be urgently reviewing its hedging policy with the help of its auditors, Deloitte Touche Tohmatsu.

According to a regulatory filing made by L'Espresso on September 9, the firm's losses incurred through "financial operations on interest rates" in the first half totalled €15.87 million, a substantial part of which *Risk* understands was paid to JP Morgan Chase. Income from investments reduced that stated loss to €14.6 million. In a July 23 press release, L'Espresso compared that figure to the previous year and stated: "The increase of the financial expenses in comparison with the same period of the previous year, equal to about €14.3 millions, was caused by the higher cost of the outstanding bonds, having chosen to change from variable rates into fixed rates on one hand, and on the other hand, because of the negative 'market value' relevant to financial operations on interest rates made in the second quarter of the year. The actions immediately implemented in July were able to limit the overall risk resulting from these operations to the cost already posted in the first half financial statements." Declining to add further detail to this statement, a L'Espresso spokesman, described the company's relationship with JP Morgan Chase as "longstanding and still excellent".

A spokesman for JP Morgan Chase insists that L'Espresso has benefited from hedging with JP Morgan Chase over the years, even allowing for the loss in 2003. The spokesman also says JP Morgan Chase's products are responsibly marketed, and that the firm has chosen to avoid certain types of client, such as Italian municipalities for example, that it feels are being sold unsuitable derivatives products by other banks. ■

Nicholas Dunbar

US broker buys Measurisk assets

New York-based broker Miller Tabak has purchased the assets of Measurisk, a US-based risk technology provider to the buy-side community, for an undisclosed sum. The deal comes after Measurisk management failed to turn the company into a viable business entity.

Measurisk chief operating officer Andrew Lapkin – an ex-Bankers Trust executive that worked on the US investment bank's Raroc project – will continue working for the new company, at present called Millar Tabak Risk Solutions. He is speaking with data vendors to renegotiate contracts in an effort to make the company profitable.

Measurisk was set up to offer risk-reporting services to the buy-side community in January 1999. Its initial backers included Morgan Stanley, Bank of Bermuda, insurer XL Capital as well as Miller Tabac. It acted as an independent provider of sophisticated financial analytics for quantifying portfolio risks for fund of funds, corporate treasuries, plan sponsors, money managers, endowments and insurers.

While risk reporting has become a critical issue for many of these companies, Measurisk found it difficult to expand from a client base of about 25 blue-chip clients. As its backers were not prepared to stump up more funds – Morgan Stanley faced a conflict of interests with its proprietary trading unit, and Bank of Bermuda failed to develop an accounting system that was going to integrate with Measurisk, says one insider – it attempted to secure external backing.

But these efforts also failed, with one investor backing out at "the eleventh hour", said another executive close to the company. Measurisk's loss-making position lay at the root of its problems – investors increasingly wanted to see profits before investing in the company, and potential clients did not want to sign up to use a company's services if the company might not be around for very long.

Measurisk was set to enter receivership, but Millar Tabak, whose co-founder Jeffrey Miller was Measurisk's chairman, decided to buy the business and radically restructure its operations. He believes if he can agree variable-rate data charges with vendors – the company used to pay high fixed rates – the business will become profitable even with a significantly thinner client base. He says those negotiations are progressing well, but nothing has yet been signed.

The next few weeks will prove critical, with former Measurisk clients awaiting the result of September 30 interim earning statement risk reports.

Measurisk spent more than £25 million developing its technology, which included data scrubbing, a risk engine and electronic delivery platform. ■

Christopher Jeffery

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