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The largest retailing FX broker falls victim to Swiss franc shock

by Victor Liu

The Swiss franc, a safe-haven currency with nearly zero inflation rate and strong gold reserves, has largely appreciated since the beginning of 2011 after the European debt crisis broke out. Facing the consistent currency appreciation, the Swiss National Bank (SNB) set a minimum exchange rate at 1.2 Swiss franc per euro on Sep 6, 2011 to prevent the appreciation from devastating its export-driven economy. Figure 1 shows that as SNB kept purchasing euro to keep the minimum exchange rate, the foreign exchange reserve significantly increased to CHF 495bn in Dec 2014 from CHF 282bn in Sep 2011.

The minimum exchange rate had been well-sustained until Russia suffered from the oil price slump and the ECB signaled in recent months that it might pursue a quantitative easing (QE) program on Jan 22, 2015 to stave off deflation and boost euro zone economy, both of which put an appreciation pressure on Swiss franc. To relieve the pressure, SNB set a negative key interest rate of -0.25% on Dec 18, but the action didn't take much effect. SNB worried that once ECB starts the QE, it needs to bring more depreciating euros into its foreign reserve to maintain the minimum exchange rate of EURCHF; in addition, Swiss franc would over depreciate against the US dollar with the peg to the euro. As a result, on Jan 15, 2015, SNB unexpectedly discontinued the minimum exchange rate of 1.2 Swiss franc per euro, a policy that has been in place for more than 3 years.

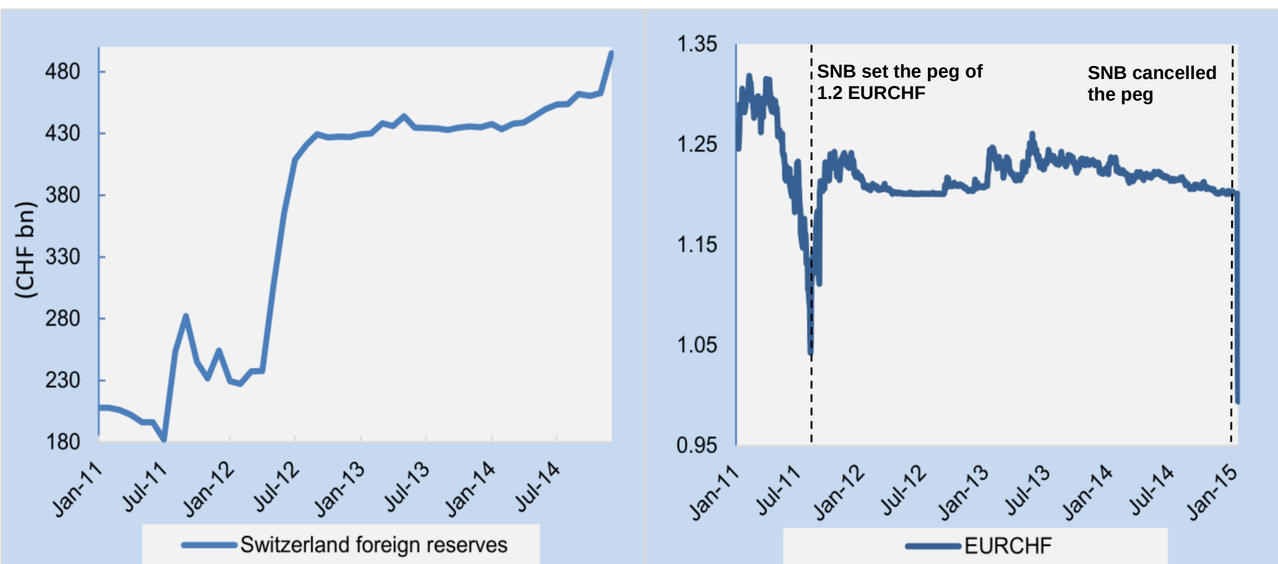

Figure 1: Switzerland foreign reserves and EURCHF. *Source: Risk Management Institute, Bloomberg*

The Swiss franc soared by nearly 30% right after the surprising move. The skyrocketing appreciation is expected to hurt the export-driven economy in Switzerland, causing the Swiss Market Index to plunge by more than 14% in 2 days. As shown in Figure 2, the RMI equally-weighted Corporate Vulnerability Index (RMI CVIew) for Switzerland captured the market shock and climbed to 30.69 on Jan 16, 2015 from 26.49 on Jan 14, 2015, the day before SNB cancelled the currency pegging policy.

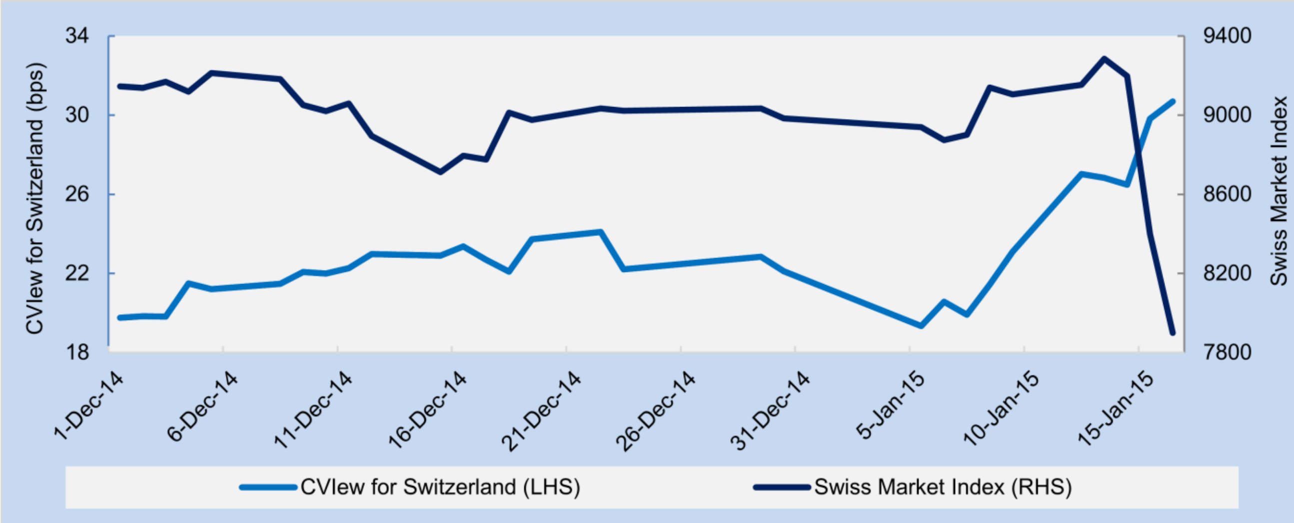

Figure 2: RMI equally-weighted Corporate Vulnerability Index for Switzerland and Swiss Market Index. *Source: Risk Management Institute, Bloomberg*

Although the export and tourism industry in Switzerland could be largely affected by the currency shock, the victim in the immediate aftermath could be those retailing brokers with lots of clients shorting the Swiss franc around the globe. For example, Alpari, a British retailing FX broker, filed for bankruptcy following the SNB announcement, while Excel Markets, a New Zealand-based broker, said that it had sustained so much loss of its operating capital that it would not be able to resume business.

The SNB's unexpected policy also put FXCM, the world's largest listed retailing broker, in trouble. As Figure 3 shows, most clients held a long position in both the trade of EURCHF and USDCHF. Hence, the abrupt Swiss franc surge made its clients suffer big losses, which exceeded the clients' account equity and was passed on to the company. In total, it was owed USD 225mn by clients, threatening the broker's compliance with the regulatory capital requirement of USD 20mn adjusted net capital. Although the company had already acquired USD 300mn bailout from Leucadia National Corp., the market cap still plummeted, pushing up its RMI 1-year Probability of Default (RMI 1-year PD) to the level of 25.69 on Jan 16, 2015 from 10.57 at the end of last year.

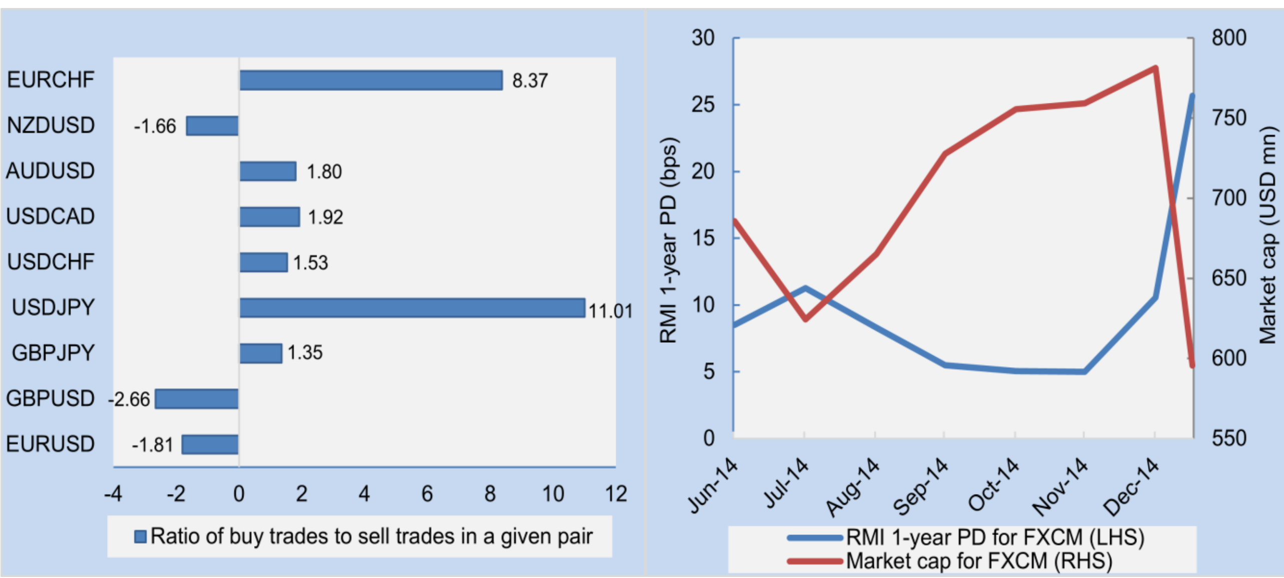

Figure 3: The positioning ratio of buy trades to sell trades in a given pair for FXCM as of Jan 16, 2015 and RMI 1-year PD vs market cap for FXCM. *Source: Risk Management Institute, Bloomberg, FXCM company website*

Due to less strict financial regulation and smaller capital, FX retailing brokers are much more vulnerable than banks. The huge losses of FX retailing brokers incurred by the Swiss franc shock are shining a spotlight on the regulators' oversight of retail currency trading. Going forward, the regulators might ask FX retailing brokers to not only decrease the leverage used by their clients but prepare more capital buffer, for fear that history would repeat itself.

Credit News

China economy grows at slowest pace in 24 years

Jan 20. China's economy grew at its slowest pace in 24 years in 2014, official data showed on Tuesday. Gross domestic product growth (GDP) is 7.4%, undershooting the government's target for the first time since 1998, which is set "around 7.5%". However, the data was still slightly stronger than expectations across the board, lead China's Shanghai Composite index widened to gain to 2%, while Hong Kong's Hang Seng index to raise 0.75% gain. Consider China's central bank cut interest rates in November for the first time since 2012, some more aggressive easing measures may be coming. (CNBC)

Government borrowing costs plumb new lows

Jan 20. Government borrowing costs fell to fresh lows on Jan 19, driven by global economic stagnation and expectations of ambitious central bank action in Europe. Japanese bond yields had been the lowest of all major countries for some time, but were recently surpassed by Switzerland, where the 10-year bond yield turned negative last week. Besides, Germany can now borrow for five years at less than 0%. Short-term government bonds yields in Japan, France, Finland, the Netherlands, Belgium, Austria and Denmark have also traded in negative territory. The expansion of negative bond yields in sovereign debt markets has underscored widespread investor gloom about the prospects for global economic growth. (FT)

Kaisa default risks waking China property bears

Jan 14. For China's property market bears, the default by a Hong Kong-listed developer on its USD bonds looks like the canary in the coal mine. They argued that more are likely to follow, as the great unravelling of the heavily indebted and oversupplied sector gets under way. Even some optimists see the recent bond and loan repayment failures by Kaisa as potentially part of a broader trend in China's property sector. However, there are still others who consider it an isolated event with political undertones that offers little insight into the sector's true health, as the company had solid sales and healthy cash cushion. Ultimately, how Kaisa's malaise is resolved will be key in determining whether this proves an unwelcome blip or something more sinister for investors. (FT)

Caesars largest unit to file own Chapter 11 bankruptcy

Jan 13. In a years-long attempt to salvage a soured buyout, Apollo Global Management LLC is preparing the largest operating unit of Caesars Entertainment Corp. for Chapter 11 bankruptcy protection on Jan 15, as a final gambit, where Apollo has USD 1.7bn invested. If persuading a judge to approve a restructuring plan will success, the unit's collection of casinos and hotels, including much of the Las Vegas Strip's iconic Caesars Palace, is expected to operate normally as it works, after transforming into a real-estate investment trust. (WSJ)

World Bank cuts forecast for growth (FT)

Asia stares at deflation with rising debt (Bloomberg)

Falling oil prices threaten electric cars and biofuels (FT)

Regulatory Updates

Bank debt issuance doubles to record levels

Jan 19. Driven by the new rules in the aftermath of the global financial crisis, global financial institutions shore up their balance sheets with unprecedented volumes of subordinated bonds, making bank debt capital issuance more than doubled to a record high USD 274.5bn last year. The debt flurry is mainly attributed to the Basel III rules stipulating that banks must hold capital, a mix of equity and debt which can potentially incur losses, equivalent to a minimum of 8% of risk-weighted assets. (FT)

Chinese stocks plunge most in six years on lending curbs

Jan 19. Concerns that speculative traders will pull back arise as regulatory taking efforts to rein margin lending. The Shanghai Composite Index sank 7.7% to 3,116.35 at the close, its steepest drop since June 2008. Citic Securities Co. and Haitong Securities Co., the nation's two biggest listed securities firms, fell by the 10% daily limit after they were suspended from loaning money to new equity-trading clients and regulators said brokerages shouldn't lend to investors with assets below CNY 500,000. The penalties have raised concern that policy makers are trying to curb a surge in stock purchases using borrowed money. (Bloomberg)

China's CSRC expands corporate bond sale rules as economy slows

Jan 19. China will allow more companies to sell bonds as authorities seek to temper a slowdown in the world's second-largest economy while balancing corporate debt levels that already exceed the US. The China Securities Regulatory Commission (CSRC) said it will allow all companies to sell notes, including non-listed Chinese companies on Jan 16. The rules, which apply to exchange-traded and privately issued bonds, took effect from that day. Previously, only Chinese brokerages and locally and overseas-listed Chinese companies had been able to raise funds selling exchange-traded securities. (Bloomberg)

China's graft-busters target state-owned firms ahead of reform (Reuters)

President's USD 110bn bank tax would hurt economy (Bloomberg)

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