

FRM Part 1

Foundations of Risk Management

Financial disasters

1. Chase Manhattan Bank & Drysdale Securities

Drysdale borrowed from chase

Bought bonds

Value of bonds declined – Couldn't repay

Drysdale bankrupt

- Drysdale exploited a flaw in computing value of collateral. (Collateral valued without considering accrued interest)
- Chase did not notice in the contract, that it would be held responsible for any payments due.
- Develop accurate methods for evaluating value of collateral.
- Approval of risk control function when issuing funds.

2. Kidder Peabody

Owned by GE (General Electric)

- Head of trading desk, Joseph Jett misreported earnings.
- Substantial artificial profits.
- Took advantage of computer's A/c error.
- Computer system used for reporting government bond activity failed to A/c for forward contract's present value.
- Importance of investigating large profits from unknown trading strategies.

3. Barings – Nick Leeson

- Hold speculative derivative positions.
- Hid positions fraudulently.
- Sold straddles & went double long positions on Nikkei.
- Earthquake hit Japan – markets went down – losses on a both positions.
- Was also the in charge of settlement process, ∴ influenced back office employees & used an old "Error A/C to book & hide losses.
- Lack of oversight process.
- Reporting to multiple managers created ambiguity.
- Management weak – failed to establish controls.
- Systems of checks and balances should be created.

4. Allied Irish Bank - AIB.

- John Rusnak – currency trader made losses in millions.
- Bullied back office workers, but their supervisor realized.
- Created fake trades to hide real ones.
- Made the strategy look less risky.
- Reported modest gains to avoid raising red flags.
- Entered false positions in the system to calculate VAR.
- AIB management inexperienced.
- Suspicious trades & profits were ignored.
- Similar to "BARINGS" but Rusnak was not running back office but he bullied them.
- OTC market contracts did not require cash settlements.

5. Union Bank of Switzerland - UBS.

- Huge investment in LTCM (Long Term Capital Market) – which failed & UBS considered it less risky. LTCM wasn't transparent.
- Too much independence to the derivative business.
- Risk manager was head of quants analytics, had his compensation tied to trading results.
- Had to merge with SBC due to losses.

6. Societe General

- Trader entered in large unauthorized trading activity. Created fake transaction to hide them.
- Cancelled the trades immediately before confirmation timing.
- Incorrect handling of trade cancellations.
- Lack of proper supervision.
- Inability of bank to check gross positions. (it checked only net positions)
- Large amount of trading commissions should have raised red flags.
- Mandatory vacation ruled should be enforced. Another trader comes in position & can uncover frequent activities.
- P/L outside normal range should be investigated.

7. Bankers trust - BT

- Procter and gamble (P&G) & Gibson greetings – went to Bankers trust.
- BT used derivatives to reduce their funding cost – using high probability to reduce cost but low probability of significance losses.
- BT made derivative structure complex.
- P&G could not get quote from other bankers.
- Thought the trades to be tailor made for them.
- Suffered huge losses.
- BT's conversations were taped -they talked about fooling their clients.
- CEO resigned.
- Important to exercise caution.
- Important to match trades with client's needs.

8. Long term capital management – LTCM

- Work with Salomon Brothers (Citigroup now).
- Generated great profits initially.
- Thus investors provided funds even though LTCM was secretive about its trading positions.
- Funds tied in long term strategy to prevent liquidation.
- Leverage 28:1 (Economic leverage increased)
- Relative value, credit spread & equity volatility strategies.
- LTCM had assumed that low frequency & high quality events were uncorrelated. VAR models thus underestimated risk.
- All strategies were based on the notion that risk premium & volatility shall decrease.
- Falling price increased mark to market. LTCM being a hedge fund had less regulatory obligation.
- Initial margin should be provided –ensure.

Need for greater disclosure, stress testing & to factor in potential liquidation cost into prices.

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