Ch 36 Derivatives Mishaps and What We Can Learn from Them

Lessons for all Users of Derivatives

Define Risk Limits

Companies should define in a clear and unambiguous way limits to the financial risks that can be taken. Set up procedures for ensuring that limits are obeyed. Closely monitor risk levels.

Take the Risk Limits Seriously

Penalties for exceeding risk limits should be just as great when profits result as when losses result.

Do Not Assume You Can Outguess the Market

Risk limits should not be changed based on successful track record.

Do Not Underestimate the Benefits of Diversification

The benefits from diversification are huge. Diversification enables investors to reduce risks.

Carry out Scenario Analyses and Stress Tests

Calculation of risk measures such as VaR should always be accompanied by scenario analyses and stress testing to obtain an understanding of what can go wrong.

Lessons for Financial Institutions

Monitor Traders Carefully

Also check that computer systems and pricing models are correct and not being manipulated.

Separate the Front, Middle, and Back Office

The *front office* consists of traders taking positions and executing trades.
The *middle office* consists of risk managers monitoring the risks being taken.
The *back office* consists of record keeping and accounting.

Do Not Blindly Trust Models

Too much business of a certain type can be just as worrisome as too little business of that type.

Be Conservative in Recognizing Inception Profits

inception profit - selling an instrument to a client for more than the model says it is worth

Recognizing these profits immediately encourages traders to use aggressive models and leave before the model and value of the deal come under scrutiny. It is better to recognize inception profits slowly, so traders are motivated to investigate the impact of several different models and several different sets of assumptions before committing to a deal.

Do Not Sell Clients Inappropriate Products

It is shortsighted to sell clients inappropriate products. This can become costly in the long run.

Beware of Easy Profits

Examples include doing business with Enron and investing in the AAA-rated tranches of the ABS CDOs created from subprime mortgages.

Do Not Ignore Liquidity Risk

It is dangerous to assume that less actively traded instruments can always be traded at close to their theoretical price. During a “flight to quality” liquidity becomes important to investors. This led to the downfall of LTCM.

Beware When Everyone Is Following the Same Trading Strategy

There can be big risks in situations when many market participants are following the same trading strategy.

Do Not Make Excessive Use of Short-Term Funding for Long-Term Needs

This can lead to unacceptable liquidity risks. This led to many failures during the credit crisis.
It also led to the introduction of liquidity ratios that banks must satisfy.

Market Transparency Is Important

Investors should understand the risks associated with underlying assets.

Manage Incentives

Discourage traders from doing trades that will look good in the short run but may blow up in a few years. Align the interests of parties during loan securitization so the originator does not have incentive to misrepresent the loan.

Never Ignore Risk Management

There is a tendency to assume that nothing can go wrong when times are good.
This has led to many stories of institutions failing due to poor risk management.

Lessons for Nonfinancial Corporations

Make Sure You Fully Understand the Trades You Are Doing

To fully understand a financial instrument, value it.
If the value of an instrument is not understood, do not trade it.

Make Sure a Hedger Does Not Become a Speculator

Clear risk limits should be set. Controls should be in place to ensure the limits are obeyed.

Be Cautious about Making the Treasury Department a Profit Center

The potential for the treasurer to make profits is limited. Profit can usually be achieved only by taking additional risks. The goal of a hedging program is to reduce risks, not to increase expected profits.