Learning from Financial Disasters

KAPLAN SCHWESER

Interest Rate Risk

- Interest rate risk flows from fluctuations in interest rate levels.
- This sensitivity can be measured using duration. The S&L crisis in the 1980s highlighted the veracity of interest rate risk.
- Banks have risk mitigation tools in the form of duration matching between assets and liabilities and various derivatives products.

Funding Liquidity Risk

- Liquidity risk is the potential for loss that results from short-term funding issues.
- The collapses of Lehman Brothers, Continental Illinois, and Northern Rock all illustrated the danger inherent with this risk.
- Each of these banks funded long-term assets (i.e., loans) with short-term funding sources.

Implementing Hedging Strategies

- When considering the implementation of a hedging strategy, a firm must choose between a static hedge and a dynamic (rolling) hedge.
- A static hedge is easy to implement but difficult to calibrate to changing market conditions.
- A dynamic hedge is flexible but it presents liquidity risk when long-term liabilities are hedged with short-term derivatives.
- The challenge of implementing a dynamic hedge was illustrated with a case study of Metallgesellschaft Refining and Marketing (MGRM).

Model Risk

- Model risk can take many forms, including making improper assumptions, measuring relationships the wrong way, and deploying the wrong model overall.
- The Niederhoffer case showed the implications of wrong assumptions.
- The Long-Term Capital Management case illustrated the need to plan for risk metrics beyond 10-day value at risk (VaR), and a need to conduct stress testing with an eye toward weathering short-term liquidity issues.
- The London Whale case showed that when risk limits are breached or trades look unprofitable, risk managers should never adjust assumptions or valuation models to make bad decisions look better.

Rogue Trading and Misleading Reporting

- A rogue trader can cause the collapse of an entire organization.
- This is exactly what happened to Barings Bank. A single rogue trader used accounting tricks to hide substantial losses. Eventually, the losses mounted to the point that a 200-year-old merchant bank closed its doors permanently.

Financial Engineering and Complex Derivatives

- Financial engineering involves the use of forwards, futures, swaps, options, and securitized products to hedge risk.
- A firm could hedge a single risk or a combination of risks depending on the hedging tool chosen.
- Risk managers should be aware of the temptation to migrate from a true hedging strategy to a speculative one.
- Case studies include Bankers Trust, Orange County, and Sachsen Landesbank

Reputational Risk

- A company’s reputation is the way in which the general public perceives the firm.
- Reputation risk is the potential for a negative operational outcome as a result of a negative fact or rumor about the firm.
- The three big constituents to watch for impact are customers, regulators, and shareholders.

Corporate Governance

- Corporate governance is a system of policies and procedures that direct how a firm is operated.
- The Enron scandal is an excellent case study in governance failures.
- The end result of the failure of Enron (beyond the subsequent failure of its auditor, Arthur Anderson) was new regulation in the form of Sarbanes-Oxley.

Cyber Risk

- Cyber risk is the risk of financial or reputational loss due to a cyberattack on internal technology infrastructure.
- The SWIFT case illustrates that the stakes are very high.
- Firms spend billions of dollars to secure their technology infrastructure and often purchase insurance to outsource their risks.