Topic 6 - Financial Disasters

Test ID: 8291804

Question #1 of 15

Question ID: 438685

All of the following affect the role of operational risk management in preventing large trading losses except:

- ✓ **A)** marked-to-market losses.
- ✗ **B)** multiple approvals for large trades by senior management.
- ✗ **C)** the degree of supervision and oversight.
- ✗ **D)** the breadth of responsibilities and power given to traders.

Explanation

Using the Sumitomo case as an example, Yasuo Hamanaka, a trader, attempted to corner the copper market. His fraudulent activities were possible because of weak operational controls. He was given broad powers, including granting power of attorney to brokerage houses, to create a financing scheme to fund his copper purchases in the spot market. Because of weak management oversight, he was able to keep two sets of books and execute large transactions without approval from senior management that would have been aware of and understood the trading strategies.

Question #2 of 15

Question ID: 438690

The head of the government bond trading desk at Kidder Peabody, Joseph Jett, misreported trades, which allowed him to report substantial profits. Which of the following statements is incorrect regarding the Kidder Peabody case?

- ✗ **A)** This case demonstrated the importance of investigating large profits from unknown trading strategies.
- ✓ **B)** The series of events resulted in $350 million in realized losses for Kidder Peabody.
- ✗ **C)** Jett's profits came under fire after Kidder Peabody realized that no individual trading strategy could produce the substantial profits that were being reported.
- ✗ **D)** The trades triggered a loss of confidence in the management of Kidder Peabody.

Explanation

After these errors were detected, $350 million in falsely reported gains had to be reversed. The series of events did not result in actual losses for the firm since the profits were fake; however, the trades triggered a loss of confidence in the management of Kidder Peabody.

Question #3 of 15

Question ID: 438689

The high degree of operational risk in the Sumitomo case was illustrated by which of the following?
I. Model risk.
II. High degree of autonomy, allowing the trader to execute highly levered positions.

- ✓ **A)** II only.
- ✗ **B)** I only.
- ✗ **C)** Both I and II.

✗ **D)** Neither I nor II.

Explanation

The lack of operational oversight gave Sumitomo's copper trader the autonomy to execute large highly-levered transactions in the spot market. Model risk is the risk that a hedging or pricing model is flawed, which is not pertinent in this case.

Question #4 of 15

Question ID: 438678

Banker's Trust used derivative trades, which promised corporate clients a high-probability, small reduction in funding costs in exchange for a low-probability, large loss. Unfortunately, the derivative trades only resulted in significant losses for its clients. This case demonstrated the importance of:

✗ **A)** incorporating liquidity risk into risk models.

✗ **B)** developing more accurate methods for computing collateral when borrowing bonds.

✗ **C)** investigating large profits from unknown trading strategies.

✓ **D)** matching trades with a client's needs and providing price quotes that are independent from the front office.

Explanation

The actions at Banker's Trust led to tighter controls for dealing with clients at other firms. This case demonstrated the importance of matching trades with a client's needs and providing price quotes that are independent from the front office. It also demonstrated the importance of exercising caution with any form of communication that could eventually be made public, as it could damage a firm's reputation if unethical practices are present.

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Question ID: 438682

Metallgesellschaft could have addressed the cash flow crisis created by their stack-and-roll hedge strategy by:
I. Selling puts.
II. Requiring periodic cash settlements from customers.

✗ **A)** I only.

✗ **B)** Neither I nor II.

✓ **C)** II only.

✗ **D)** Both I and II.

Explanation

Metallgesellschaft's long stack-and-roll hedge strategy created interim cash outflows that triggered a liquidity crisis for the firm because petroleum prices dropped dramatically and because the market shifted from backwardation to contango. Requiring periodic cash settlements from its customers on the fixed rate contracts would have mitigated this cash flow crunch. Another solution would have been to purchase put options, which would have generated cash to offset marked-to-market losses and margin calls as spot prices declined. Selling puts would have further exposed the firm to declining petroleum prices.

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Question ID: 438688

Which of the following choices is an example of operational risk in the collapse of Barings?

- ✗ **A)** Much of a company's assets were in illiquid derivative products.
- ✗ **B)** The default of Japanese industrial firms.
- ✓ **C)** Failure to supervise the actions of its trader.
- ✗ **D)** The Nikkei collapsed due to an earthquake.

Explanation

The failure to supervise the actions of its trader is an example of operational risk.

Question #7 of 15

Question ID: 438683

Nicholas Leeson is identified with which of the following?

- ✗ **A)** Commodity Futures Trading Commission.
- ✗ **B)** Sumitomo.
- ✗ **C)** Metallgesellschaft AG.
- ✓ **D)** Nikkei stock index futures.

Explanation

Nicholas Leeson was a trader for Barings PLC and was speculating in Nikkei options and futures.

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Question ID: 438687

Information systems at Barings Bank were deficient for all of the following reasons except:

- ✓ **A)** technological limitations that hindered accurate financial reporting.
- ✗ **B)** management's failure to audit reporting quality.
- ✗ **C)** incomplete account information on gains and losses.
- ✗ **D)** management's inability to detect the inconsistency of Leeson's trading strategy and profits.

Explanation

The Barings collapse did not result from technological limitations. Management is responsible for auditing and ensuring the quality of the information it receives. Barings management failed to do so and received information without questioning it. Reports contained incomplete account information on gains and losses. Management also failed to detect a signal that something might be wrong in that the size of Leeson's reported profits were inconsistent with and out of proportion to the trading strategy he was supposedly using. Technological limitations were not an issue in the Barings case.

Question #9 of 15

Question ID: 438686

All of the following are reasons that Nick Leeson engaged in aggressive speculative trading in the Barings Bank collapse except:

- ✗ **A)** Barings' lack of risk management oversight.
- ✗ **B)** he was attempting to recover previous trading losses.

- ✓ **C)** Barings' risk management models were flawed.
- ✗ **D)** his authority over settlement operations allowed him to hide trading losses.

Explanation

The collapse of Barings Bank was not an instance of flawed hedging models, but one of poor operational control. Leeson had previously incurred huge trading losses that, if revealed, would have cost him his job. In an effort to recover those losses, he abandoned his hedging strategies and speculated to recoup these losses. His influence and authority in back office operations allowed him to hide his speculative losses and report phantom profits. Leeson ignored and exceeded risk control limits, and senior management's lack of understanding about Leeson's role and oversight allowed his schemes to go undetected.

Question #10 of 15

Question ID: 438684

The high degree of operational risk in the Sumitomo case was illustrated by which of the following?
I. Lack of informed supervisors to approve large trades.
II. The trader's ability to keep two sets of trading books and hide trading losses.

- ✗ **A)** Neither I nor II.
- ✓ **B)** Both I and II.
- ✗ **C)** II only.
- ✗ **D)** I only.

Explanation

The large trades in the both the spot and futures market should have required the approval of a supervisor who was informed about the trader's strategies and competent to understand them. The trader's broad authority allowed him to manipulate the reporting system and thereby hide his huge losses.

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Question ID: 438691

In general, the bankruptcy of Barings Bank might have been avoided with:

- ✗ **A)** a more moderate use of leverage.
- ✗ **B)** maturity matching between the hedging instrument and the asset being hedged.
- ✗ **C)** pricing models less vulnerable to model risk.
- ✓ **D)** stronger reporting and control systems.

Explanation

In general, the Barings Bank collapse was the result of poor operational controls characterized by poor reporting systems, weak management oversight, and poor organizational structure. Leeson's dual responsibility for trading and settlement enabled him to hide trading losses in accounts that were not reported to management.

Question #12 of 15

Question ID: 438676

Which of the following are examples of model risk illustrated in the Long-Term Capital Management (LTCM) case?
I. Poor management oversight.

II. Financial reporting standards.

- ✗ **A)** II only.
- ✗ **B)** I only.
- ✗ **C)** Both I and II.
- ✓ **D)** Neither I nor II.

Explanation

LTCM's models underestimated the extent to which securities prices would move together in times of economic crisis. The models also failed to anticipate that multiple economic shocks might occur in clusters through time (i.e., be positively autocorrelated) as economic history suggests. Poor management oversight and financial reporting standards are not issues in the LTCM case.

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Question ID: 438679

Between 1997 and 2002, a currency trader for Allied Irish Bank (AIB), John Rusnak, hid $691 million in losses from management. Rusnak used a number of deceptive means to hide these losses including:

I. bullying back-office workers into not following-up on trade confirmations for imaginary trades.
II. reporting substantial fake gains from small currency arbitrage positions.

- ✗ **A)** II only.
- ✗ **B)** Neither I nor II.
- ✓ **C)** I only.
- ✗ **D)** Both I and II.

Explanation

Management believed that Rusnak was running a small currency arbitrage trading strategy. However, the strategy actually being implemented involved very large currency positions. Rusnak made a point of only reporting modest gains as to not raise any red flags.

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Question ID: 438681

Metallgesellschaft's mismanagement in its long-term fixed contract strategy was evidenced by which of the following?
I. Refunding payments to customers who willingly paid to cancel their long-term obligations.
II. Canceling the program too soon while the positive legs of the contracts could have been sold at a profit or used to secure additional financing.

- ✗ **A)** Neither I nor II.
- ✓ **B)** Both I and II.
- ✗ **C)** I only.
- ✗ **D)** II only.

Explanation

Metallgesellschaft committed both errors in its handling of its liquidity crisis.

Question #15 of 15

Question ID: 438677

Which of the following factors contributed to the collapse of Barings Bank?

- ✗ **A)** Japanese financial reporting requirements.
- ✓ **B)** A trader having authority in the settlement process.
- ✗ **C)** Basis risk.
- ✗ **D)** A maturity mismatch between the hedging instrument and the risk being hedged.

Explanation

In an effort to recover trading losses, Nick Leeson abandoned hedged arbitrage strategies on the Nikkei 225 in favor of extremely speculative strategies that exposed the firm to enormous risk in the event of a market downfall. His activities went undetected because his influence on the settlement process and back-office operations allowed him to report phony gains to management. Reporting requirements, basis risk, and maturity mismatch were not factors in the collapse.