

**Class:** TY BSc

**Subject :** Risk Management & Investment Management -1

**Chapter:** Unit 3 Chapter 1

**Chapter Name:** Case Studies – Financial Disasters

# We previously learned

- The whole Enterprise Risk Management (ERM) framework though should focus around integration of risk management and hence a central risk management unit.
- The major benefits of having an ERM program are : Increased organizational effectiveness , Better risk reporting and Improved business performance.
- Costs for ERM programs can be broadly divided into two categories, recurring and non-recurring or one-time costs.
- Organizations that make rational investments in risk management and are proactive, optimize their risk profiles. These investments are more than offset by improved efficiency and reduced losses.
- The Chief Risk Officer (CRO) is the head of an independent risk function in an organization.
- The CRO is tasked with providing the overall leadership, vision, and direction for ERM, establishing an integrated risk management framework for all aspects of risks across the organization while also communicating with senior management and other stakeholders of the organization.
- The CRO interacts with the Board of Directors on a consistent basis. Establishing a dotted-line reporting relationship between the CRO and the board helps smoothen the friction between the CRO and the CEO.
- The CRO also interacts with the audit & compensation committees and increasingly, the risk management committee, to form execution plans and keeps an eye on compliance.

## Continued...

- The duty of the board is to make sure that all the mechanisms used to delegate and drive risk management decisions are functioning properly.
- An independent risk advisory director is a board member who intimately understands the risk factors of a given industry and can advise the board on specialized risk exposures. The role involves educating members on best practices in both corporate governance and risk management.
- The risk management committee (a subset of the full board of directors) is responsible for setting the firm's risk appetite and independently monitoring ongoing risk management.
- The compensation committee is independent of management. Its role is to discuss and approve the remuneration of key management personnel.
- Audit committee is responsible for monitoring risk management procedures, tracking the progress of existing systems, and affirming the efficacy of the existing policies/systems.
- The core components of an ERM program include Corporate Governance, Line Management, Portfolio Management, Risk Transfer, Risk Analytics, Data and Technology Resources and Stakeholder Management.
- The risk culture of a firm is the goals, customs, values, and beliefs (both implicit and explicit) that influence the behaviors of employees.
- The Financial Stability Board (FSB) has specified four culture risk indicators : Tone from the top of the organization, effective communication and challenge, incentives and accountability.

# Topics to be covered

1. Financial Disasters
2. Operational Risk
  1. Chase Manhattan & Drysdale Securities
  2. Kidder Peabody
  3. Barings

# 1 Financial Disasters

## Introduction

- One of the fundamental goals of financial risk management is to avoid the types of disasters that can threaten the viability of a firm. So we should expect that a study of such events that have occurred in the past will prove instructive.
- Financial disasters can snowball into full blown financial crisis if the institution concerned is systemically important and can have a domino effect on other counterparties.
- Therefore studying past financial disasters is both important and necessary.
- Financial Disasters can be caused by a variety of factors and we'll learn about some of the factors and the disasters going further.

## 2 Operational Risk

**Operational risk** refers to potential losses flowing from inadequate (or failed) internal processes, human error, or an external event.

- Operational risk could relate to factors such as inadequate computer systems (technology risk), insufficient internal controls, incompetent management, fraud (e.g., losses due to intentional falsification of information), employee mistakes (e.g., losses due to incorrect data entry or accidental deletion of a file), natural disasters, cyber security risks, or rogue traders.
- Often, insufficient control measures or misleading reporting leads to such failures. They are classified under Operational Risk but **Misleading Reporting** can also lead to reputational risks.
- It's one of the most common causes of financial disasters and has oft been repeated throughout modern history. We'll learn about some of the famous incidents related to it.

## 2.1 Chase Manhattan Bank & Drysdale Securities

### What Happened?

- Drysdale Government Securities, obtained unsecured borrowing of about \$300 million by exploiting a flaw in the market practices for computing the value of U.S. government bond collateral while having just \$20 million in capital. Its traders took positions on the bond market and lost money so Drysdale went bankrupt, losing virtually all of the \$300 million in unsecured borrowings. Chase Manhattan absorbed almost all of these losses because it had brokered most of Drysdale's securities borrowings.

### What was the cause?

- Chase employees believed they were only acting as agents on these transactions and were not taking any direct risk on behalf of Chase though they were legally they were the risk takers.
- Drysdale utilized a weakness in trading markets to obtain its funds.
- It is highly unusual for a single firm to bear this large a proportion of this large a borrowing sting.
- Drysdale employees took systematic advantage of a weakness in valuation techniques for the bonds they were trading.

## 2.1 Chase Manhattan Bank & Drysdale Securities

### What could have been done better?

- Aside from the obvious fact that Drysdale could have acted in good faith, there were a few other failures too.
- The Chase managers who handled these accounts were relatively inexperienced and should have been monitored by senior management or someone with more experience while such vast quantum of investments were being brokered.
- There should have been a system in place to double-check such transactions while also looking at the **legal risk** involved in these transactions more thoroughly.

### Result:

- Chase Manhattan absorbed a majority of the losses but it didn't face solvency issues because of the relatively small size of transactions in the overall picture.
- The bank also suffered reputational damage which led to a sharp fall in the stock price in the immediate future and which remained suppressed for a few years after the incident. Thus shareholders did face some losses.

## 2.2 Kidder Peabody

### What Happened?

- From 1992, Joseph Jett, head of the government bond trading desk at Kidder Peabody, entered into a series of trades that were incorrectly reported in the firm's accounting system, artificially inflating reported profits. When this was ultimately corrected in April 1994, \$350 million in previously reported gains had to be reversed.

### What was the cause?

- A flaw in accounting for forward transactions in the computer system for government bond trading failed to take into account the present valuing of the forward. This enabled a trader (Joseph Jett in this case) purchasing a cash bond and delivering it at a forward price to book an instant profit. Over the period between booking and delivery, the profit would inevitably dissipate, since the cash position had a financing cost that was unmatched by any financing gain on the forward position.
- Joseph Jett exploited the opportunity and made spectacular gains, albeit only on paper.

## 2.2 Kidder Peabody

### What could have been done better?

- As was the case with Drysdale, management controls were very loose.
- The fact that Jett was making such extraordinary returns were overlooked on many occasions suggesting some complicity on behalf of the management which didn't seem to mind the good returns that were generated, although very suspiciously so.
- The computer system error which allowed this to happen should also have been vetted out before being uploaded to such a widespread system.

### Result:

- Jett's trades had not resulted in any actual loss of cash for Kidder, the announcement of such a massive misreporting of earnings triggered a substantial loss of confidence in the competence of the firm's management by customers and General Electric, which owned Kidder. It was a reputational loss and GE sold Kidder which was further dismantled by the acquiring firm.