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Risk

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50 Ways to Lose Your Money

Warren Edwardes - Chief Executive - Delphi Risk Management Limited

Warren Edwardes is CEO of Delphi Risk Management, the London-based financial product creativity, communication and control consultancy. He is founder of the b2b netucation start-up schoolofbanking.com at the London international school of banking and finance. Warren was previously on the board of Charterhouse Bank and has worked in the treasury divisions of Barclays Bank, British Gas and Midland Bank. He first researched into what were later to be called "derivatives" in 1975 and was part of the team that executed one of the world's first currency swaps in 1981. Since then he has devised and transacted numerous structures that form part of the history of derivatives.

"To put it simply and directly, if the bosses do not or cannot understand both the risks and rewards in their products, their firm should not be in the business."
William J. McDonough, President, Federal Reserve Bank of New York

Acquisition Risk

Do you really know what you are buying? Even if the price to be paid to the receivers is a nominal GBP1, what is the true value of the assets and liabilities of the firm that you are buying? In some countries, bank accounting is highly creative. On the other hand, as the target of acquisitive companies, are you spending too much management time fending off predators?

Careless Error Risk

Over-confidence leads to errors. I still vividly remember as a raw but cock-sure dealer nearly twenty years ago, saying, "buy dollars" when I meant, "buy pounds". It was highly embarrassing but it was quickly sorted out. Fix the problem immediately.

Competitive Risk

Don't put off that product too long, even if it is going to compete with existing products. Somebody else will build a better mortgage product if you do not. Like Virgin Direct! Don't rely on superior current market share. Be innovative or ready to immediately react to competitors.

Commodity Risk

Are your customers subject to gold or other commodity prices? Gold or copper producers could have their borrowing liabilities linked to the gold price. See Energy Risk.

Communication Risk

Send that confirmation now! See Language Risk. And avoid jargon. Don't talk about strangles and straddles. What is really going on in the deal? Tell it like it is.

Competence / Understanding

If you don't understand your dealers, don't let them do it! Don't be afraid of your own ignorance. Go on a course - or buy a book. Don't be afraid to ask seemingly stupid questions. See Fraud (staff) risk

Concentration of assets Risk

Large Exposure Risk is obvious and there are central bank limits in most (but not all) countries. Sometimes governments direct banks to lend to certain champion industries. Later, of course, they have to call the International Monetary Fund!

Concentration of liabilities Risk

Diversify your liabilities. Retail bankers have fewer liquidity problems than wholesale bankers do. Do not place yourself at the mercy of a few lenders. See Liquidity.

Concentration of business type Risk

With the merger of Citicorp and Travelers into Citigroup, it seems that financial supermarkets are again the fashion. On the other hand, Barclays Capital says in its advertisements, "Stick to your strengths". But if the market moves and regulations change, can you reinvent your institution?

Convertibility Risk
Also known as Deliverability risk. Can the currency be converted and delivered into a freely tradable currency? Non Deliverable Forwards are widely used in Asia and in Eastern Europe, partly in an attempt to neutralise this type of risk.

Country Risk
Do you really understand what is happening in Indonesia or Korea? Can you control your Asian subsidiary from afar without offending everyone? Or your aggressive Californian subsidiary or branch without killing motivation?

Credit Risk
So how much has the customer borrowed elsewhere? Has your client used off-balance sheet finance excessively? Will the parent or government really stand by that bank? You could buy these new fashionable credit derivatives. But see Legal Risk. Know your customer. Not just the firm but the human being you are dealing with.

Cultural Risk
"My word is my bond" is the rule in London. But be warned. It does not apply everywhere, even after contracts have been exchanged! Contracts are sometimes seen as a basis for negotiation. See also Fraud (customer) Risk.

Currency Economic Risk
Japanese producers faced severe competition from Korean producers post the devaluation of the Korean Won. The Japanese suffered from Economic exposure with respect to the Won. Few corporate treasurers hedge economic exposure.

Currency Translation Risk
It is the risk of revaluation of foreign assets or liabilities as a result of a movement in currency value. No cash flow here. There may be taxation difficulties. Not many corporate treasurers hedge translation exposure.

Currency Transaction Risk
This is the risk that foreign currency receivables will change in home currency terms. But what is a loss? How are you, as the treasurer, measured? Are you measured against the spot rate outcome? Or against the forward rate at the time the underlying transaction is made? Or against the average exchange rate over the year?

Customer Satisfaction Risk

Do your customers like doing business with you? Will they come back for more of the same? Do they call you for other products?

Disaster Recovery Risk
Are you prepared? If you lose GBP 80 million on interest rate Caps, what does the market think of you? Be sure to watch carefully traders who are making substantial profits. If they say it is "arbitrage" make sure it is. Genuine arbitrage is still possible. However, if the profits are speculation generated, they will probably turn into losses! See Fraud (staff) risk.

Economic Activity Risk
A slowdown in economic activity will affect your business. Your overheads have still to be paid for. A downturn in international trade will effect the foreign exchange and financing business of banks.

Energy Price Risk
Do you have airline customers who could use energy derivatives? Oil producers, such as Mexico, have had the interest rate on their bond liabilities linked to the price of oil. See also Commodity Risk.

Environment Risk
If you lend to polluters, you may be faced with competition from a bank like the Co-operative Bank that does not. See Image Risk.

Equity Market Risk
Are you about to launch a rights issue? Use equity derivatives to hedge the issue. But do check regulatory compliance issues to be sure that you cannot be accused of insider trading.

Fraud (banker) Risk
Has your banker misrepresented that complex geared swap? Make sure you tape all conversations - learn from Linda Tripp.

Fraud (customer) Risk
Will your client say that he did not understand that complex geared swap? All will be fine if the client is "in the money". He will only cry "foul" if things start to go sour for him!

Fraud (staff) Risk
This often follows a covered-up disaster. See Disaster Risk. And watch the traders

who don't take holidays. Many an irregularity has surfaced when a trader who never took a holiday fell ill and his position was taken over by a colleague.

Image / PR Risk

A recovery from a bout of bad publicity is extremely difficult. See Disaster Risk and Fraud (banker) Risk. Keep the media, rating agencies and your Counter-parties fully informed of any potential difficulties. Prepare a list of questions and answers for your CEO. No fund manager or treasurer wants to hold an asset or do business with a bank that suffers from adverse reporting in the media.

Information Risk

Keep your mouth shut and ears open especially in bars in the City of London or Wall Street or in other financial centres. Read the Financial Times on the train or the aeroplane. Even a small piece of information may be somebody else's missing link. Not so long ago a train commuter sitting next to me was reading his papers on the way to work. It was headed "Confidential: "Big" Bank Product Development Department". And beware of the boastful. In my experience the most leaky are the most senior.

Inflation Risk

Many utilities have inflation-linked price controls. Issuing a bond linked to inflation allows them to provide an investment vehicle to pension funds and other savers who seek to generate inflation-adjusted annuities.

Interest rate Risk

Are you selling fixed rate mortgages? If you are in the property business, even if you are not financing, you suffer from interest rate risk. Demand for property is linked to interest rates. As a retail banker, your cheque account business will lose profitability as interest rates fall. Overheads are fixed costs.

Interaction Risk

The same as Correlation risk. Is the Hong Kong Dollar or Saudi Riyal really fixed to the US Dollar? What if monetary union within Europe fails and the Euro collapses?

Language Risk

When your customers / subordinates say "Yes", do they just mean, "I heard you?" See Communication Risk. Also be careful about the symbol M. It may mean a million or a thousand!

Legal Risk

Were those nice UK Local Authority swap dealers acting Intra Vires? Do you really think that Credit Derivatives are not insurance contracts and therefore prohibited to banks in most countries?

Liquidity Risk
Also Solvency Risk. Liquidity is much less about holding liquid assets than about managing and diversifying liabilities. Remember Continental Illinois! See Concentration of liabilities Risk and Image Risk.

Morbidity Risk
Are your staff sickly? Alcoholics? Drug users? Don't be too reliant on any one person. Or is someone likely to impact on others' performance through racist or sexist remarks?

Mortality Risk
See Morbidity Risk but only more so. Copy the Royal Family. Catch separate flights on trips. And don't even think about buying key-man insurance. Just make sure that at least two people can do the job.

Operational Risk
This is everything other than market related risks.

Performance Measurement Risk
Any dealer worth hiring can manage his management accounts and can show bookkeeping profits at the expense of real losses. Dealing mandates provide only a little more protection than a comfort blanket. See fraud (staff) Risk.

Political Risk
What will happen if there is a coup in Indonesia? Will the new government abide by the IMF's terms? Will the IRA or ETA bomb your dealing room?

Property (Real Estate) Risk
Do your property asset-backed loans have sufficient cover? Is the property liquid? Also see Interest rate risk.

Rating Agency Risk
What if Moody's and S&P downgrade you or your investments? There is evidence that lower rated bonds default more than higher rated bonds. I am reminded, however, of the sick man who refused to go to bed. More people die in bed than in the living room. Other than the financial market equivalent of a car crash (Barings?),

corporate mortality is usually associated with firms in deteriorating stages of morbidity.

Regulatory Risk
If you operate in several countries you may face inconsistent rules. Some countries insist on branches be ring-fenced for regulatory Capital purposes.

Religious Risk
Is interest Hallal or Haram? Is usury a problem? A particular form of Ethical risk. See also Environment Risk and Image Risk.

Resignation Risk
Will the star dealing team move to a competitor after you buy the bank? Maybe there should be football-style transfer fees in dealing rooms?

Settlement Risk
Remember Herstatt? This is the risk that you meet your part of the bargain and your Counterparty does not. Herstatt Bank collected Deutsche Mark receipts on foreign exchange contracts but did not fulfil its US Dollar payment obligations. There are now netting procedures in place to avoid this problem.

Systemic Risk
Financial instability is contagious. Financial systems are closely inter-linked. Instability in Indonesia or Korea has a domino effect on Hong Kong, Tokyo and London.

Tax Risk
What did you write on that tax-based savings scheme document? In 1997 substantial losses were suffered by equity index option writes. Changes in the treatment of the tax credit associated with UK shares surprised the market just when margins had narrowed through competition.

Technological Risk
A missing fax was the cause of recent inter-bank dispute. A fax was sent exercising an option. It was sent to a fax machine in the bank writing the option but apparently it was never received by the options desk. I receive several stray faxes for a major law firm every week. Before sending an important fax, check the number; after sending it, confirm receipt.
Other than the Millennium bug there is also the Dow Jones 10,000 scare. Can your systems manage? Can you cope with computer / telephone system failure? Also see

Political Risk. Establish a second dealing room elsewhere.
Transport Risk Remember the crash of 1987? That day there was a severe storm in London. Trees were blown onto railway tracks. Many were late for work.
Weather Risk See Environment Risk and Transport Risk.
No Risk This final risk is the most insidious and dangerous risk. "No Risk" is the risk of having a risk manager who always says "No" and who comes up with 50 or so ways not to do the business. Of course, you will never appear to lose money. You will never be known for making a wrong decision. It is just that the business will go elsewhere and your firm will find itself with unemployed capital! "It's impossible to take an unnecessary risk. Because you only find out whether a risk was unnecessary after you've taken it" Giovanni Agnelli, President FIAT

This article, "50 ways to lose your money", forms the basis for Appendix 1 of the book: "Key financial instruments: understanding and innovating in the world of derivatives" by Warren Edwardes. The book is published by Financial Times Prentice Hall ISBN 0273 63300 - copyright Pearson Education and Warren Edwardes 2000.

Question or Comments

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