Derivatives Mishaps and What We Can Learn from Them

Chapter 30

Big Losses by Financial Institutions

- Allied Irish Bank ($700 million)
- Barings ($1 billion)
- Chemical Bank ($33 million)
- Daiwa ($1 billion)
- Kidder Peabody ($350 million)
- LTCM ($4 billion)
- Midland Bank ($500 million)
- National Bank ($130 million)
- Sumitomo ($2 billion)

Big Losses by Non-Financial Corporations

- Allied Lyons ($150 million)
- Gibsons Greetings ($20 million)
- Hammersmith and Fulham ($600 million)
- Metallgesellschaft ($1.8 billion)
- Orange County ($2 billion)
- Procter and Gamble ($90 million)
- Shell ($1 billion)

Lessons for All Users of Derivatives

- Risk must be quantified and risk limits set
- Exceeding risk limits not acceptable even when profits result
- Do not assume assume that a trader with a good track record will always be right
- Be diversified
- Scenario analysis and stress testing is important

Lessons for Financial Institutions

- Do not give too much independence to star traders
- Separate the front middle and back office
- Models can be wrong
- Be conservative in recognizing inception profits
- Do not sell clients inappropriate products
- Liquidity risk is important
- There are dangers when many are following the same strategy

Lessons for Non-Financial Corporations

- It is important to fully understand the products you trade
- Beware of hedgers becoming speculators
- It can be dangerous to make the Treasurer’s department a profit center