

# Lecture 1

## BUS 492 *Risk Management*

- Class Organization
- What is Risk Management?
- History of Risk Management and Derivative Securities
- Exchanges, OTC and Available Contracts

# Class Organization

## Review of Course Syllabus

- Discussion of Course Objectives
- Course Text and Reading Materials  
*Required Text is “Risk Management, Speculation and Derivative Securities” (RSD)*
- Evaluation of Grade
- Formation of Groups

# What is Risk Management?

- Risk management is a diverse subject
  - ◆ Areas involving risk management cover medicine, nuclear engineering, national defense and security analysis
- Methods for managing risk are a necessary adjunct to everyday life
  - ◆ What is Risk? → Distinction between risk and uncertainty

# Risk Management Decision Problems

- Sensible approaches to risk management involve, firstly, a corporate risk management philosophy
  - ◆ Imposes guidelines on risk management decision-making. → what kinds of risks to bear? what risks to avoid? what sort of options to consider in managing risks, etc.

# Making Risk Management Decisions

- ◆ What risks to bear? → risks where there is some particular expertise (e.g., risk unique to the particular line of business)
  - ◆ What risks to avoid ? (e.g., the risk of a factory burning down).
- The risk management philosophy should give an indication of what attitude to take towards various types of risks

# History of Risk Management and Derivative Securities

- Reading: RSD, sec. 1.2
  - ◆ Derivative Securities in Antiquity
    - Mechanics of Trading in Early Markets
    - The Bill of Exchange
  - ◆ From Antwerp to Amsterdam
    - Unbundling the Embedded Option
    - The Evils of Derivative Securities

# The Canadian and US History

- The US History
  - ◆ Transplanting of European Practices
  - ◆ Origins of the CBOT
  - ◆ The Distrust of Derivatives
  - ◆ The Experience with Options
- The Canadian History
  - ◆ The Winnipeg Exchange and the Wheat Board

# Recent Derivative Debacles

- Reading, RSD, sec. 1.3
- The Hunt Silver Crisis
  - ◆ Mechanics of a Short Squeeze
  - ◆ Events in the Silver Market
- Portfolio Insurance and the Crash of '87



# More Debacles

- The Collapse of Long Term Capital Management
  - ◆ What is a Hedge Fund?
  - ◆ Derivatives and Hedge Fund Strategies
  - ◆ When Genius Failed
- Nick Leeson and Barings Bank
  - ◆ The Leeson Strategy
  - ◆ Types of Risks: Operational vs. Market

# EVEN MORE DEBACLES

- The Sumitomo Copper Manipulation
  - ◆ The Long Run for Mr. Hamanaka
- China Aviation Oil
  - ◆ Another rogue trader
- Amaranth Advisors LLC
  - ◆ Regulatory Confusion

# Types of Pure Derivative Securities

Reading: RSD, Sec. 1.1

- What are Derivative Securities?
  - ◆ Various possible designs:
    - Forward vs. Futures Contracts
    - Types of Options
    - Swaps and Other Variations

# Free Standing Derivative Securities

- Accounting and Derivative Securities  
FAS 133 is the primary source of US GAAP rules governing the use and valuation of the common 'free standing derivative security contracts': futures, forwards, options, and some types of swaps.
- Accounting plays a fundamental role in revealing the risk management activities of corporations. Group presentations uncover this information.

# The Exchanges

- **US Exchanges**

- ◆ *Chicago Board of Trade merged with the Chicago Mercantile Exchange which merged with the NYMEX which merged with the COMEX, etc. → BIG CME*

- **Offshore Exchanges**

- ◆ *Europe and East Asia*
- ◆ *Canadian Trading*

# Exchanges vs. OTC

- Center of trading activity differs across commodities, examples:
  - ◆ Currencies
  - ◆ Oil
  - ◆ Eurodollars
- **Public Policy Issues**
  - ◆ Innovation and Secrecy
  - ◆ Regulatory Oversight

# Basics of Futures Contracts

- **Contract Features**
  - ◆ **Standardization**
- **Daily Marking to Market**
  - ◆ **Hedgers vs. Speculators**
- **How do Margins Work?**
  - ◆ **Types of Margin Requirements**