Derivatives' Risks Remain Unchecked

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LONDON — Despite last year's devastating losses trading derivatives, many investment-management companies still lack the ability to measure and control the risks associated with these volatile instruments, according to a new study by accountants Ernst & Young.

In 1994, such companies as Piper Jaffray Cos., Cargill Inc., PaineWebber Group Inc., Prudential Securities Inc. and BankAmerica Corp. all had derivative-related losses. Investments in funds managed by Askin Capital Management were wiped out.

"A lot of the problems were precipitated by the fact that people didn't have the proper risk-management policies, procedures and controls," says William G. Ferrell, chief executive of Ferrell Capital Management, a Greenwich, Conn., trading and risk-management firm. "They didn't have the proper risk-measurement technology and methodology, and they didn't have the independent risk-management oversight function."

Guess what? "We found there is still a need for investment funds to improve their monitoring and control of derivative usage," says Steven E. Buller, head of investment-management services at Ernst & Young in New York.

His firm's survey covers 143 investment concerns in the U.S., Britain, France and Ireland that together manage more than $535 billion. Included are mutual-fund com-

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panies, the asset-management divisions of banks and investment banks, insurance companies and investment subsidiaries of nonfinancial companies. Roughly a third of them — overwhelmingly U.S. institutions — said they used one derivative product or another.

Hedges and Speculations

Derivatives are financial products whose returns are linked to — or derived from—returns on some other asset, such as stocks, bonds, currencies or commodities. During the past decade, they have been used increasingly by banks, corporations and money managers to hedge risk and to speculate in global markets.

Ernst & Young found that the most common instruments used by the firms responding to its survey were foreign-exchange "forwards," contracts to buy or sell a set amount of foreign currency at a predetermined price on a specific date. Close behind were exchange-traded futures, and options on stocks and interest rates.

The new survey found that almost two-thirds of the money-management firms that use derivatives lack a supervisory board or risk committee that has responsibility for setting limits on the use of the instruments. Where limits were set, the decisions were often based on unsophisticated measures. What's more, few firms had an individual on their board with a background in either risk-management or complex financial instruments.

"The highly publicized losses in derivatives will force boards to look at and understand these risks," says Joan Zimmerman, an executive vice president at executive recruiters G.Z. Stephens Inc. in New York. She adds that while the biggest U.S. investment banks have developed very sophisticated systems for dealing with risk, "on the fund-management side, that kind of risk management at many firms hasn't been applied across all markets and products."

Reliance on Brokers

The Ernst & Young study also discovered that computer systems used by investment firms are often unable to correctly price many of the products used by their money managers and traders. As a consequence, many firms rely on brokers to value derivatives, a dangerous practice that might not reflect the true cost of executing a trade or the liquidity of a particular instrument.

At many firms, portfolio managers or traders are responsible for determining a derivative's market value, a procedure fraught with potential for conflicts of interest. The survey shows that while 60% of all firms using derivatives have someone other than traders review market prices daily, 15% do so less frequently and 25% don't at all.

"The growing reliance on derivative products, coupled with the lack of sophisticated monitoring techniques, should be a concern at many" fund-management companies, says Ernst & Young. "The lack of integrated front-office trading and back-office valuation, control and reconciliation functions can compound already weak systems and procedures."

Recommendations Not Followed

The report added that many of the widely accepted risk-management techniques recommended in July 1993 by the Group of 30, a Washington-based think tank, "are absent" in some firms and that no company has adopted all of them.

Perhaps the most glaring flaw born out by the Ernst & Young study is the lack of oversight and control at many firms. For instance, 75% of them don't employ risk-management teams independent of the company's trading function. Fifty-five percent permit traders to authorize the use of derivatives on the company's behalf. Nearly two-thirds don't use independent third parties to evaluate the logic behind pricing models used for over-the-counter, or nonexchange-traded, derivatives.

Nonetheless, "We're finding that your astute money managers know they've got to do something and are starting to do something," says Mr. Ferrell of Ferrell Capital. With "the old way of looking at things, the only way you knew you had a problem was to lose money first. Risk-management helps you know the risks you are taking first."