

Graduation Ceremony 4
Graduand's Address
Wednesday 23 November 2011 at 1630hrs
JESUITS' CHURCH – VALLETTA

Simon Grima
Ph.D graduand and representative of the students

I would like to start by thanking our Rector Professor Juanito Camilleri and the members of Senate for inviting me to give this speech. I would also Like to thank those persons who have made this day possible: most notably my supervisor, Professor Joseph Falzon, the Head of Banking and Finance, Dr. Saviour Gauci the Dean of the Faculty of Economics, Management and Accountancy and my research methodology advisors Dr. Joseph Azzopardi and Dr. Frank Bezzina. I thank you all for your help and constant guidance during my years of study.

I would also like to thank my wife, Leanne my sons Luke and Steven, My Mother and all the remaining members of my extended family. Moreover, I dedicate my thesis to the memory of my beloved father.

I am well aware that on such a day what you require of any speaker is brevity. I shall not fail you in this respect. In the coming few minutes I will be highlighting the main aspects of my study, which focused on the use and misuse of financial derivatives.

A derivative put simply is a financial instrument that has a value determined by the price of something else, such as an index, a commodity, and an exchange rate. Its use is mainly for hedging and can take the form of an option, a future, a swap or a forward.

I embarked on this study after gaining considerable experience in the field of finance as a treasurer, internal auditor and a risk manager with local banks, investment companies and governmental regulators.

This study was enticed by the many large losses blamed on derivative use. I wanted to understand the reasons why the financial world is divided into two:

- those who embrace financial derivatives as the 'Holy Grail' of the new investment area and
- those who denigrate derivatives as the 'Financial Antichrist'.

The latter, does not come as a surprise, since although derivatives are the most efficient risk management tool that allows you to hedge away any type of risk, nearly all the major collapses of firms were attributed to derivatives. The largest collapse happened in 2008 at the hands of Societe General's Jerome Kerviel, with a loss of US\$7.1 Billion.

I will now highlight a few of the worldwide cases that resulted in spectacular losses, so as to enable the understanding of the implications of such an instrument:

- The two Hedge funds, **Amaranth Advisors** in 2006 for a loss of US\$6.5 Billion at the hands of Brian Hunter and **Long-Term Capital Management** in 1998 for a loss of US\$ 4.6 Billion at the hands of John Meriwether,
- **Sumitomo Corporation**, in 1996 for a loss of US\$2.6 Billion at the hands of Yasou Hanamaka,
- **Bawag** in 2006 for a loss of US\$2.5 Billion at the hands of Wolfgang Flotti and Helmut Elsner,
- **Orange County** in 1994 for a loss of US\$1.7 Billion at the hands of Robert Citron, and
- **Barings Bank** in 1995 for a loss of US\$1.4 Billion at the hands of Nick Leeson.

The main aim of the study was to determine those factors that affect the proper use of derivatives. To achieve this, I made use of both qualitative and quantitative analysis. I started by analysing the reasons behind the failure or large losses suffered by 5 international firms, which include Barings Bank Plc, Allied Irish Bank, Société Générale, Metallgesellschaft and Enron.

I also analysed the current financial crisis and conducted a series of interviews and exchanged emails with derivative experts and internationally renowned traders and controllers such as:

- **Mr. Nick Leeson** – the person who brought down Barings Bank in 1995 and after serving a jail sentence is currently a very popular guest speaker at Universities and International conferences on financial losses.
- **Professor Robert Jensen, Ph.D.** a renowned researcher on derivatives,
- **Mr. Ira Kawaller**, founder of Kawaller & Co. and the Kawaller Fund . He was the Vice President-Director of the New York Office of the Chicago Mercantile Exchange,
- **Professor Frank Partnoy, Ph.D**, a previous Wall Street trader turned lawyer and consultant on financial regulation and markets, author of books such as F.I.A.S.C.O. and Infectious Greed and who was involved in the inquiry about the use of derivatives at Enron; and
- **Professor Christopher L. Culp, Ph.D**, who featured in the investigation of Metallgesellschaft.

Using a thematic approach, the factors affecting the proper use of derivatives that emerged from the above analysis could be categorised under 5 main headings, namely, Controls, Expertise and Knowledge, Perception, Benefits and Characteristics. A

questionnaire was constructed and administered to 420, international users and controllers of derivatives to determine whether derivatives are the reason behind the problems of firms and the financial crisis and explore the governing factors that influence the proper use of derivatives.

In a nutshell, the study revealed that derivatives are not the main reasons behind the problems of firms and the financial crisis. The latter is mainly due to the:

- **lack of use of appropriate risk management controls,**
- **lack of expertise in handling derivatives particularly in complex situations,**
- **a negative perception of derivatives,**
- **a lack of awareness of the benefits that derivatives provide to firms when handled properly; and**
- **various factors such as personal greed, political interference, inadequate controls and inappropriate standards and structures.**

Therefore, the study provides **qualitative and empirical evidence** that the *incorporation of control factors* as well as *demographic factors* such as *Education and Experience* make a significant contribution to the understanding of proper derivative usage.

Additionally, if the implication of such factors is not looked into, then the true value and qualities of the derivative instrument are obscured.

This study was a very positive learning experience and I hope that my study will encourage other persons to take up further research in this important area of finance.

Finally, I conclude with what Nick Leeson's argued during an interview aired on BBC regarding the US\$2.3 billion loss made by Swiss Bank UBS in September of this year. He said the problem was partly because of the "*speed and complexity*" of the financial industry, which made it difficult for regulators to keep up. Additionally, the financial scandal boiled down to very simple controls not being in place and regulators always being behind the curve.

Thank you very much, and I wish you all a pleasant evening.