QUANTIFYING HERSTATT RISK

by Steve Brown

Of all the risk factors for banks, one that is most often overlooked is settlement risk. Any time a bank enters into a contract to exchange monies or services it takes on this risk. Few models capture this hazard, and few banks adjust earnings or capital to account for this danger. In Europe, they call this "Herstatt Risk" after the Bank of Hersttat went from being well capitalized to shutting down in a period of 6 hours, after failing to complete a large foreign currency transaction almost 30 years ago. Since then, Drexel Burnham and Lambert, BCCI, Barings and some 35 other financial institutions have ultimately met their demise because of settlement failure. To quantify settlement risk, the theoretical calculation looks something like this: Settlement risk = (net value at risk x volatility of the net value x time outstanding) + risk factor of settlement. The result is a dollar amount of the transaction, which is "at risk" due to settlement failure. The "risk factor of settlement" adjusts for four subcomponents: credit/liquidity, legal, operational and systemic. Of all those, systemic risk has been historically ignored. Now, post September 11th, this risk is material. Few banks have quantified what the cost would be if the Fed wire, the phone system or investment safekeeping went down for 2 days or more. The longer the period of settlement, the more resources a bank should put into developing technology, processes and procedures. While having a system to quantify credit/liquidity risk is common, only the largest banks have a process that allows for legal, operational or system quantification. For example, very few banks adjust pricing when taking on a loan participation, despite the fact that this contains greater (although still admittedly relatively small) settlement risk versus a direct loan. The participation agreement, plus the reliance on another party, all create additional menace. It may be interesting to note that we keep tabs on this settlement risk for each of our customers. For example, when we sell a $5mm mortgage backed security we are taking on approximately $28k in risk for the average settlement. When we sell loans, while this asset class has lower volatility, it is less liquid and has a longer settlement. As a result, our average $5mm loan settlement risk is $37k (for clients with settlement risk management procedures, our risk calculations are available to you on a complimentary basis). We admit that on a relative basis, settlement risk pales in comparison to interest rate and credit risk. However, our point here is that settlement risk is far too often only given lip service. As the ex-CEO of the Bank of Hersttat said after the debacle, "a low probability event created a disastrous loss."

BANK NEWS

Acquisition

Nat City Investments Inc, the investment banking subsidiary of National City Corporation ($142B, OH) will acquire the investment banking business of SSG Capital Advisors. Terms of the transaction were not disclosed.

Deficit Report

According to the Treasury Department, the U.S. federal deficit fell to $33.2B in July, down 38% from the prior year level of $53.4B.

Fined

Citigroup Inc. has been fined $1.1mm by the NASD after more than 100 of its brokers were found to have falsely claimed that clients were disabled, qualifying them for waived fees on mutual-fund sales.

The scheme involved nearly 2,400 transactions totaling $47mm taking place between 2001 and 2002.

Merger Savings

According to a recent study examining 420 M&A transactions, only 45% of the mergers reached the cost savings goals that were stated at the time of the announcement of the deal. Over-optimism, failure to get the required head count reductions and problems with system conversions were all cited as major pitfalls that prevented management from reaching their goals.

Cell Phone Ban

More banks are banning use of cell phones within branches in an attempt to increase security and prevent criminals from planning getaways and casing the layout with camera phones.

Check Images

A recent poll found that more banks and credit unions are able to receive check images, further eliminating the need to print image replacement documents.

Perks

Companies such as Microsoft and General Mills are increasing perks to employees in an attempt to make them happier. Some perks include a free towel service at the company gyms, a cost which was eliminated in a $60mm cost cutting campaign several years ago.