CASE STUDY

## The CDS trader

### The story

##### A bad omen

Life in the Market Risk and the Management Results departments was calm. The routine was even a bit too grey and monotonous, every day following the same pattern: at the beginning, pretty much until lunch time, check all night processes, collecting all closing information from previous day and preparing the daily reports; then, after lunch, came the time of checking the already sent reports in search of something special and finally send to Treasury and to Management. Occasionally there was an amber alert, approaching the limit position threshold, some other day even a red one, but never anything too out of normal.

Nothing indicated that this day this alert would be different: a certain CDS position entered in the amber zone, fact that was obviously noted in the *positions to watch* section in the report. However, something different happened: opposite to other cases, this time the Credit desk didn't do anything. Next day it was exactly the same, fact that was of course noted again.

##### Entering the red zone

Too strange that the second day also nobody took any action. Kasia, the Risk manager responsible to oversee the Credit desk, didn't particularly pay attention to this fact, as the notionals didn't grow at all – at least the position stopped growing. This situation seemed to be repeating day after day for about two weeks with the notionals slightly growing, fact that made Kasia be a bit worried, but still there was nothing to escalate. Finally, that position crossed the red zone threshold, which meant having more than 4 MM PLN in unrealized loss. That had an obvious effect on the reporting: the CDS position left the *positions to watch* section to enter the *Exceptions*, plus a specific comment in the body of the daily email. However, a not that obvious consequence happened: no action was taken afterwards.

This time not only a couple mails were sent, but direct phone calls to Treasury followed:

* Hi Marcin. This is Kasia from Risk. Did you notice the CDS exception?
* Hi Kasia. Yes I have seen. Don't worry, everything is fine.
* Ok, good. So, can I expect it to return to green level?  Sure, don't worry. Everything will be fine.

The next day, Kasia was horrified: the position went much higher in notional and also in unrealized loss, almost reaching the 8 MM PLN. She noted the fact again, and this time she specified the fact very clearly in the body message:

Please note that the CDS position has an 8 MM PLN unrealized loss, over the 4 MM PLN threshold. Please take corrective action.

##### Deeper into red, going to black

The next day, Kasia was horrified: the position went much higher in notional and also in unrealized loss... And no, that's not a déja vu! This time the losses were reaching the 9 MM PLN. Kasia had no other option than escalate. Her manager Dorota also had no other option than escalate to the CRO:

* Hi Rafał, this is Dorota. I know that normally you are not involved in the daily positions report, but this is getting out of control. I don’t know what happens in Treasury, but it can’t stand. I tried to contact Jurek and he is just ignoring me.
* Hi Dorota. Yes I see the report. Don't worry. I have to see him today evening, as we have a family dinner. I will remind him.

Jurek, the Treasury manager, was quite a character: arrogant, too self-confident, but indeed very good at his job. Year after year he managed to get positive results, and make Treasury to be a decent player in a Bank almost 80% devoted to SMEs and classical credit products. He married Rafał’s niece three years ago and in this time they became close friends. The same day Rafał was convinced that Marcin was an excellent Credit trader that knew very well what she was doing, as clearly this CDS was preparing a very aggressive rebound, all the indicators were in the same direction. Rafał didn’t take any further action, as he considered this small issue out of control.

After two days, the CDS just collapsed, and the notional kept growing. Now the losses approached the 17 MM PLN. Rafał was just ignoring Dorota, who at the end took a very brave and risky action: forward the mail to Rafał’s boss. The Board of Directors quickly reacted:

* Hi Rafał. This is Józef. What’s going on there?
* Hi Mr. President. Don't worry, everything is under control.
* I don't think so Rafał, how can you tell me that a 17 MM PLN loss is under control? I want a full explanation. I want everybody involved tomorrow in the main meeting room.

The meeting in front of Józef was a nightmare. Jurek blamed Risk for the losses, directly pointing Kasia for not taking any action, and Rafał admitted that Dorota was quite bland sometimes to control Risk levels. But Józef pointed directly Marcin, asking him why he didn't control the position when Market Risk asked so.

The next day the CDS even went worse, and by the moment the position was fully closed as per Józef’s precise order, the losses were close to 19 MM PLN. And now what? Who will pay for this?

### Discussion

Comment and discuss the following questions:

* Was the Market Risk Management framework well established? What failed?
* Who should be pointed as responsible for these losses? Why?
* Apart from the obvious Market Risk, what other risks are involved in this case?
* What should be done from now to better mitigate these risks' effects?