National University of Science and Technology

Think in Other Terms

FACULTY OF COMMERCE

BANKING DEPARTMENT

DISSERTATION:

AN EVALUATION OF THE ADEQUACY OF ZIMBABWEAN BANKS' MARKET RISK MANAGEMENT SYSTEMS FOR DERIVATIVES TRADING 2003-2009

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ABSTRACT

This dissertation evaluates the adequacy of Zimbabwean banks' market risk management systems for derivatives trading. The Monetary Policy Statement of July 2009 authorised banking institutions authorised to trade in foreign currency to trade in derivatives. In the wake of the failed derivative activities of the year 2003, and of globally publicized derivative mishaps the likes of Barings Bank, Metallgeselschaft, Long-Term Capital Management, it is imperative that a study on the adequacy of risk management systems for derivatives was undertaken. The major objectives of the study were to examine how banking institutions identify and measure market risks inherent in derivatives, assess the adequacy of market risk monitoring and control systems for derivatives, review the sufficiency of the regulation and supervision of derivatives in Zimbabwe and to determine the extent of banks' compliance with Basel II requirements on market risk treatment of derivatives. To obtain data for the study, the research methodology used encompassed the survey research design and participative observation. Under the survey research design, the sample populations were the banks, and the bank examiners. Stratified sampling was used for banks, which were grouped into commercial and merchant banks, being the banks authorised to deal in foreign currency in the country. From these two classes, judgmental sampling was also use to ensure that banks that previously traded in derivatives were part of the sample. From bank examiners, random sampling was used to select a sample of 18. Participative observation was used in that the researcher in part of the examiners at the Reserve Bank of Zimbabwe's Bank Licensing, Supervision and Surveillance Division and was involved in on-site examination of banking institutions' risk management systems in general. Further, the researcher was also involved in the team formulating guidance to the banking sector on the risk management of derivatives. Data collection instruments used were questionnaires and interviews. Two questionnaires were designed, one for bank examiners and another for banks. A total of 33 questionnaires were administered to the sample population in the following way, 10 to commercial banks, 5 to merchant banks and 18 to bank examiners. The response rate to the questionnaires was an average of 76%. The major findings of the study were that % of respondents indicated that banks market risk management systems for derivatives were deficient in as far as risk measurement systems were concerned. All

banks' risk measurement systems save for those banks that are foreign-owned, (Standard Chartered Bank, Barclays Bank, and Stanbic Bank), were outdated and did not have a provision for quantifying risks in derivatives. Risk monitoring and control was also rated inadequate as banks' boards of directors and senior management were yet to amend relevant policies to cater for derivatives trading, risk limits for derivatives were also still be set. The regulation and supervision of derivatives was noted to be insufficient. There is need for additional guidance on the types of derivative activities that are permissible and those non-permissible. The framework on derivatives should also contain adequate information on how banking institutions can distinguish between a hedge transaction and a speculative one. The Reserve Bank of Zimbabwe's Bank Licensing, Supervision & Surveillance should also consider enhancing its skills and knowledge of regulating and supervising derivatives through consulting experts in the field and also through considering attaching staff members to economically advanced jurisdictions. In the future, studies should cover assessment of liquidity risk in derivatives, corporate governance issues in derivatives, and developing a model for computation of economic capital taking into account derivative activities.