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ROGUE TRADING
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Will your bank be the next?
How to deter your own rogue traders

IT COULDN'T HAPPEN HERE....

Within your Delta 1 Equity Derivatives group, do you employ a likeable 28 year old male index derivative trader who has been promoted to the trading floor, initially as a trader's assistant, from a middle office trade support or product control function? Does he have a very good understanding of your back- and middle-office systems and processes, including where the weaknesses are? Does he have a decent finance or business-related degree from a good (but not top-end) university? Was joining the bank his first permanent employment after graduating?

If so, please go and take a closer look at what he's doing. Based on the experience of Societe Generale and now UBS it is entirely possible that he has just started (or is just about to start) to take small directional bets on particular index or stock futures which he is pretending to hedge using fictitious trades, and which - if successful and undiscovered - may fractionally increase his bonuses. If he's left alone, in three years' time you will probably discover you have a hidden unrealised trading loss of about $2bn, which you will lose a significant further sum unwinding, for which he will be arrested and subsequently tried, and you will be pilloried by shareholders, regulators and press alike.

THE *KERVIBOLI* TWINS

A number of commentators have picked up on clear similarities between the cases of SocGen's Jerome Kerviel and UBS' Kweku Adoboli. Based purely on an analysis of the information and reporting already available, those similarities become breathtaking, rather than merely noteworthy. Expanding on the profile drawn above:

Jerome Kerviel	Kweku Adoboli
Delta 1 Turbos trader at SocGen	Delta 1 ETF trader at UBS
Former trade support/control	Former trade support
Non-establishment background	Non-establishment background
Decent degree at secondary university	Decent degree at secondary university
Straight to SocGen after university	Straight to UBS after university
Unsocial	Sociable
SocGen say single person acting on his own	UBS say single person acting on his own
Supposed to be client facilitation	Supposed to be client facilitation
Mainly trading index-based derivatives	Trading index-based derivatives
DAX, EuroStoxx, CAC and FTSE index futures, and single stocks	DAX, S&P500 and EuroStoxx index futures

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Jerome Kerviel
Took unhedged directional positions
Created phantom offsetting trades
Fictitious hedges based on OTC index futures and ETFs
Forward trade and settlement dates to help hide
Booked fictitious trades against internal counterparties
Subsequently booked to external counterparties
Initial unrealised loss $2bn (€1.4bn)
SocGen discovered through checking an alleged counterparty
Activity dated back three years from discovery
Concerns about trader also raised 3 months before discovery
Illicit trading started small and became much larger
No possibility of personal gain except bonus
Aged 31 when arrested
Knowledge of back office processes and controls key to fraud
Widespread failure of risk and control structure and supervision

Kweku Adoboli
Took unhedged directional positions
Created phantom offsetting trades
Fictitious hedges based on OTC ETFs
Extended forward settlement dates to help hide
Booked fictitious trades against internal counterparties
Subsequently booked to external counterparties
Initial unrealised loss $2bn (€1.45bn)
Adoboli admitted it to management following questioning
Activity dated back three years from discovery
Trader also questioned 2 months before discovery
Illicit trading started small and became much larger
No possibility of personal gain except bonus
Aged 31 when arrested
Knowledge of back office processes and controls key to fraud
Widespread failure of risk and control structure and supervision

THE RISK OF RISK MANAGEMENT

Modern banking involves a significant number of relatively bright people, spread across a number of support and control departments, who are responsible for making sure that processes and controls are operating, and who know what to do - because it's standard operating procedure - when some sort of material exception arises. The knowledge that these people and processes are in place, and performing as required, tends to give senior management a warm, comfortable feeling that the sun is shining, and things are under control, allowing them to focus on profitability and new business. This is particularly true in low risk areas, like Delta 1.

Delta 1 is perceived as low risk because it's a client facilitation business where all positions are supposed to be hedged. However, where it is essentially an arbitrage play, taking advantage of a small mismatch in the pricing of two similar instruments, the notional trade size is often very large to massive. The hedge means that the net risk is relatively small, as the two sides of the trade approach a delta of 1. The ability to create a OTC forward synthetic contract which can be hedged with futures means that the characteristics of the client trade can be matched perfectly, effectively replacing market risk with counterparty risk to the counterparty, and leaving the net market risk approaching zero.

Which is fine in theory as long as the trade is real. Where the trade is fictitious, as with both Kerviel and Adoboli, it's a naked punt on the futures market and the market risk is enormous - as SocGen and UBS (and previously Barings) discovered.

THE SIMPLICITY OF CONTROL

The CEO of UBS has been quoted as saying of Adoboli that "If someone acts with criminal intent, you can't do anything". We beg to differ. The best controls are preventative.

Whilst our view is necessarily subjective and speculative, we would not be particularly surprised were the UBS investigation to discover, inter alia, that:

- Delta 1 risk management focused on the net trading risk without paying sufficient attention to the gross size of positions
- Trades booked against internal counterparties were effectively treated as book entry transfers rather than actual trades
- The control functions accepted explanations that they didn't fully understand for discrepancies around Adoboli's unauthorised trading
- Adoboli's unauthorised trading, spread back three years, was initially profitable
- Adoboli used extended settlement dates for his fictitious trades in the somewhat rickety synthetic ETF market to justify deferred receipt of counterparty trade confirmations, cancelling and rebooking or substituting trades prior to the deferred settlement date, just ahead of the amber light turning red

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- The development of control and risk management systems had not kept pace with the development of the Delta 1 business
- Adoboli's trading generated a significant volume of errors and amends
- His supervisors did not pay sufficient attention to the alerts received from the various operations and control functions
- Whilst there was inadequate coordination between the various control and settlement functions, there was no great failure to follow procedures
- That Adoboli's access rights to back office systems weren't removed when he became a trader, or that he had access to a former colleague's ID and password
- His detailed knowledge of back- and middle-office systems meant he was regarded as an asset to the trading team, rather than a significant risk

Each of these issues, where relevant, would be conceptually simple to address: the solutions to a number of them require a refocusing of resource, rather than an increase. Some of it, we acknowledge, is about the culture of an investment bank and the position of the control and support staff - but if that needs significant change then problems and losses are going to arise anyway.

The simplest element in concept but often hardest in practice is to gain an effective overview of the issues arising within the various control and operations functions and to identify correlations between them - the linking factors. Frankly, if you have a high level of cancels and amends within the settlements area originating from one trader, and at the same time the trader is taking on significant gross trading risk even though the net approaches zero then Houston, we have a problem. One person or group needs to be able to see the outputs and indicators originating from the various silos in order to have a chance of linking them.

Other issues are easier. It should be a no-brainer to identify a trader who has a detailed knowledge of back- and middle-office systems as a higher risk, who consequently warrants a higher level of risk and compliance monitoring. It is relatively easy to make chasing confirms a back-office to back-office control, rather than getting the trader to talk to his counterparty.

Subjecting accounts used for large internal 'trades' to a much higher degree of scrutiny as a matter of routine isn't particularly difficult. Requiring trading management to provide evidence-based responses to escalations, and requiring the control staff to continue questioning traders until they get an answer that they can both understand and believe, is simply a matter of management discipline.

Unauthorised profits, however large, should be treated with precisely the same degree of severity as unauthorised losses - however unnatural that may feel for a trading desk.

A final point is that where staff move internally between functions that are IT-intensive, there should be a simple standing process to strip their old access rights at the same time as authorising their new ones.

FINAL THOUGHTS

It is too early to draw conclusions - the loss was only announced seven days ago - but it is not too early for firms to take actions. It seems likely that UBS did not adequately learn the lessons of Mr Kerviel's escapades at SocieteGenerale, consequently allowing Mr Adoboli the freedoms to repeat them. The direct parallels between the two cases, even on the basis of the information known now, are shocking - spooky, even.

People (including traders) do more bad things when economic circumstances are challenging and revenue harder to come by - it's inevitable. Despite the economic situation, and the extraordinary burden of dealing with current regulatory demands, firms really must act now to validate that the level of control they think they have over trading floor activities is borne out in reality.

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The author, Nick Gibson, was closely involved in overseeing the Barings aftermath during his 11 years as a regulator, and subsequently worked for over a decade in a number of roles with ABN AMRO, including as head of the global wholesale business compliance function and as a member of the group compliance management team.

Chase Cooper is staffed and run by former senior practitioners in the area of risk, compliance and governance. We take a practical, business-focused view, because we've been there and done it ourselves.

If you would like to discuss this article with us, please call Nick Gibson on 0207 826 9013 or e-mail on nick.gibson@chasecooper.com.

If you would like to meet to discuss your own internal control environment and current or proposed review we will be more than happy to come to you.