



## See Who Rises to the Rogue's Hall of Fame

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Regulators should consider making this a mandatory read for those who advocate for repeal of the Volcker Rule, because no one should forget or disregard the many painful lessons caused by the rogues since the [downfall of Barings](#).

Rogue traders bore their fair share of blame in a long list of [trading losses](#). However, have top bosses learned from history and taken sufficient corrective actions at their financial institutions (FIs)? Moreover, have policy-makers taken a strong enough stand to curb against speculative risks that have repeatedly brought the economy to its knees?

This is NOT a story about corporate governance and risk culture; rather, it's a showcase of how little the industry have learned from these cases.

A. [Nick Leeson](#) of Barings plc – \$1.1 billion loss in 1995

***Claimed to have learned:***

Segregation of duties between front- and back-office to avoid conceal of losses and/or fraudulent acts.

***What yet to be learned:***

Audit could have caught the situation easily (e.g. via confirm procedure), so why weren't their voices being heard? Were they being bullied or were their qualified opinions simply being disregarded?! The board's audit committee could have suspended the operation until a satisfactory resolution, but why they didn't exercise such authority?!

The losses could have also been contained after the first margin call/warning signal, so why did the management of this 233-year-old bank grant Leeson so many exceptional approvals to double-down on his losses?! Leeson's activities had generated losses totaling \$1.3 billion, twice the bank's available trading capital. The bank executives who put up the money behind Leeson's one-sided risky bets indeed became implicit endorsers!!

Though 21 top executives at Barings were ousted when the organization crumbled, should the board and management have faced more severe consequences? Their sins included gross negligence; and failure to establish compliance programs that was reasonably designed to ensure and monitor compliance; and failure to recognize trades that were in excess of reasonably expected near term demands (RENTD). All of these, in fact, would have been considered prosecutable crimes if the Volcker requirements has been in effective back in 1995.

B. [Jérôme Kerviel](#) of Société Générale (SocGen) – \$7.2 billion loss in 2008

***Claimed to have learned:***

No-one watching doesn't mean rogue is allowed to steal. Yet, Kerviel bought into [Daniel Bouton](#)'s lip service about SocGen's internal control strengths, even stating the followings during his 2008 testimony: "The techniques I used aren't at all sophisticated and any control that's properly carried out should have caught it."



***What yet to be learned:***

Kerviel was accused of exceeding his authority to engage in unauthorized trades totaling as much as \$73 billion, a figure far higher than the bank's total market capitalization. Both this case and the downfall of Barings illustrated that heightening of capital requirements offers little to no help when faced with outsized risky bets.

The magnitude of unauthorized trades is humongous. The frequency of control breaches were over an extended period (2006 to 2008). There were also suspicions on whether Kerviel did act alone (see [this](#)). SocGen's board and management could have acted upon any warnings much sooner, but were they repeating the Barings episode? Kerviel was using "hedges" as a convenience excuse. If the trades had been made under today's regulation, they won't have it qualified for the Volcker's hedging exemption.

Whenever fake trades were questioned, Kerviel was slick to cancel the trade, and followed that by replacing the bet using a different instrument to avoid detection. [Modern surveillance technology](#) would have looked out for suspicious trade patterns, prompting for a timely review. But was SocGen's management being "blindsided" back then? Well, as recently as 2016, CEOs still shamelessly claimed being "[blindsided as bank added to risky positions](#)" that contributed to \$1 billion in trading losses.

Volcker RENTD requirement is about the right amount of trades at the right time, yet the industry continues to struggle to properly account for securities inventory. RENTD, what RENTD?!

C. [Kweku Adoboli](#) of UBS – \$2.3 billion loss in 2011

***Claimed to have learned:***

Adoboli turned himself in to UBS and unveiled this episode of unauthorized trades. The case has regulatory disciplinary action against more than one person – Adoboli and [John Hughes](#) (a former senior trader).

***What yet to be learned:***

Adoboli was exploiting deficiencies in the trade process as a carousel for his unauthorized trades (see [this](#)). Hughes did not declare these trades in the desk's profit and loss report, which led to him permanently banned from working in finance.

It was later discovered that UBS failed to act on a warning issued by its computer system. So, why did the bank not properly follow up on the computer warning? Moreover, why were two people in the front-office able to mobilize as much as a \$50 billion portfolio?! There was segregation of duties between front- and back-office, but how diligent were they in enforcing (bilateral confirmation with counterparties, reconciliation of internal trades) controls?!

Because management was only looking at the "net" risk exposure, not the breakdown, Adoboli's fictitious hedges made the bank's risk limits exposure look much smaller. Such misconduct would have been prevented under the Volcker regime, because: (i) [§ .5\(b\)](#) have rigorous requirements to qualify for "risk mitigating hedge exemption"; (ii) RENTD requirements call for a comprehensive tracking of securities inventory positions, and hence analyses may therefore be conducted on a play-by-play basis, rather than letting trades get blurred by the "net risk limit."



After his release from jail, Adobli's interviews with [Financial Times](#) and [BBC](#) suggested that institutions are pushing their traders to make difficult choices, and that the gambling practices will continue. "The industry doesn't learn ... The culture is set at very senior levels of the industry," Adobli elaborated. "They [bosses] have as much responsibility for what the outcomes are as those pushing the buttons."

D. [Unresolved Mystery](#) of JPMorgan Chase (JPMC) – \$6.2 billion loss in 2012

***Claimed to have learned:***

The U.K.'s Financial Conduct Authority abandoned a proposal to fine the trader Bruno Iksil \$1.4 million and refrained from banning him from the industry. He also reached an agreement with the U.S. to testify against others for allegedly hiding the extent of the losses. The US Federal Reserve has shelved its threat of legal action against Iksil thus far. Possible prosecution against other involved individuals is still pending in the U.S.

***What yet to be learned:***

Anyone who complains about the cumbersome requirements under [§ .5\(b\)](#) of the Volcker Rule hedging exemption, can blame this case. The [2013 Senate Hearing](#) highlighted the following flaws at all levels:

- "Increased risk without notice to regulators
- Mischaracterized high risk trading as hedging
- Hid massive losses
- Disregarded risk
- Dodged Office of Comptroller of Currency (OCC) oversight
- Mischaracterized the portfolio"

JPMC's Synthetic Credit Portfolio (SCP) increased tenfold in 2011, and then tripled again in early 2012 to \$157 billion. The mandate for this SCP trading desk was to execute long-term hedges to reduce the bank's risk. In reality, the trades of more than 100 synthetic derivatives were compiled – and were too complex to unwind, with no tangible way to stop losses.

JPMC's Chief-Investment-Office (CIO) tried to finesse the problem, but ended up blowing it up even more than their original bets. This case illustrates that price can fluctuate significantly in a split second, and that proprietary trading can cause disastrous amount of trading losses (as well as systemic risk to the markets).

When this perplexing case exploded, the [New Yorker](#) wrote an article about it. "How did JPMC – a creator of the prominent Value-at-Risk (VaR) method for risk measurement – end up misusing its risk-measurement tool?!" the author asked in astonishment.

A different article, from [Bloomberg](#), noted that "risk limits were breached more than 300 times before the bank switched to a more lenient risk evaluation formula — one that underestimated risk by half!!" What's more, [exhibits](#) from a 2013 Senate Hearing provided evidence of how massive losses were hidden. Attempts to disregard JPMC's risk as a "tempest in teapot" and/or play down the sins as "[spreadsheet error](#)" are shameful. Anyway who is upset about the [Basel VI](#) restrictions on internal models may cast their blames on JPMC. This is because JPMC's slick practices have



tarnished trustworthiness of banking sector to reliably access risks and to provide accurate, timely, and complete information to the regulators.

### Before jumping to the conclusion

It's easy to raise the alarms about corporate governance and risk culture improvements. However, what good is this when top bosses may just be paying lip service or bragging about its control strengths, as in the SocGen case?!

Installing new people and/or adding several thousand pages to policy and procedure manuals may merely be scratching the surface of problems. What's the point in arguing about the needy-greedy of risk modeling or the use of metric report to enforce compliance? When losses compound and pressures are heightened, would people still act on their best behavior, or would they compromise their morals and disregard warnings? Would the juniors be forced to make difficult choice? Would risk limits, valuation models, and other risk measurements be tweaked to retrofit the circumstances??

The Volcker Rule rightfully banned proprietary trading because speculative risks are uninsurable. Those who support the adoption of UK "ring-fencing" rule to watered-down the Volcker Rule should be reminded of the [collapse of LTCM](#), [Bear Stearns](#), and [Lehman Brothers](#). These weren't commercial banks, but their systemic risks spilled over to the broader markets.

Blindly following the 1933 version of Glass-Steagall to partition commercial and investment banks only passes the buck to benefit lawyers. Once the Volcker Rule is relaxed (without the details and/or speed to curb abuses), all hell will break loose, and fictitious hedges will come back to haunt financial stability!

### Details and Speed

Banks are like [alchemists](#) and devil is in the details. Without stitching details into the bigger picture, one can only "guesstimate" how much is at risk from complex synthetic trades. Thus, a "play-by-play" instrument approach to securities inventory is essential for electronic audits. Regulators should therefore consider removing [79 FR 5592 – Footnote 711](#) (see point (6) of my last [thread](#) for details), instead of requesting banks to submit unnecessary metric reports for Volcker.

To curb abuses and unwind or resolve complex issues around synthetic trades, capital markets' risk practices need to be more agile. What's more, to stop losses in a timely fashion; risk intelligence is critical.

To prevent institutions from digging into deeper holes, warnings must be duly acted upon, and there should be automatic triggers to notify regulators for effective enforcement. The end-to-end processes should be digitized, moreover, to ensure regulators won't be blocked from asking for more details – and that data can speak for itself to minimize intrusion.

What concrete improvements have been made to address modern-day financial engineering challenges (e.g., [clock synchrony](#))? Well, I think the industry still has a lot to learn.

### Rogue Hall of Fame

The rogue of all rogues is hard to identify. He/she may appear as slacker to foster a weak control environment. He/she might also be slick enough to induce others into wrongdoing while orchestrating crimes behind the scenes.



Top rogues willfully disregard warnings or intentionally delay curbing of violations, implicitly endorsing impermissible behaviors. If risky bets resulted in huge profits, they'll win big and pamper their subordinates with bonuses, salary raises, or promotions. When things turn bad, top rogues may selectively allow their favorite colleagues to conceal small losses while quietly dismissing one or two who are unwilling to collude.

I may be speculating about the extremes and imaginary rogues, but evil plots and fraud collusion aren't anything new in the financial services industry. Investigation and detection are always difficult, yet control functions may consist of sloppy people having an [IBG/YBG](#) mentality that causes enforcement to be even harder to implement. If regulators surrender to the challenge and if policy makers adopt a *see no evil/ hear no evil* attitude toward disruptions to financial stability, they may as well include their names in this Rogue's Hall of Fame!

***P.S. Further research suggestions:***

- 1.) How sloppiness should be punished, while not deterring talents from working in risk and compliance?*
- 2.) Advancing risk practices through collaborations between the industry and regulators for automated surveillance.*

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