Lessons from the recent UBS loss of $2B – part 1

By

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The rogue trader

- Kweku Adoboli
- 32 years old
- Joined as a trainee five years ago!
- Worked three years in a "back office" position as a trade support analyst
- Last worked on UBS's "Delta One" desk as director of exchange traded funds in European equities division at UBS, London
- Informed his colleagues of the problem
- Has taken on the law firm Kingsley Napley (who represented Nick Leeson)
- Ten days ago, he had delivered a potential hint at rapidly-growing losses when he wrote on his Facebook page: "Need a miracle."
- His misdemeanors might stretch back to 2008!

The Man

Delta trading

- Delta trading—the name is derived from the fourth letter of the Greek alphabet—is a gauge of risk exposure for bets made on the movements securities such as stocks and securities
- Jérôme Kerviel, the Société Générale trader who was responsible for $6.8 billion in losses in 2008,worked on a Delta Trading desk!

Delta trading contd.

- Buying a derivative easier or less risky than buying the asset itself.
  - Instead of buying bars of gold, a hedge fund manager may buy an exchange-traded commodities fund, or even a gold fund.
- Attractive because they require little upfront capital!
- Wall Street firms try to profit from the tiny differences between the values of the derivatives and the underlying assets.

Delta trading contd.

- In recent years, the desks have generated billions of dollars for Wall Street firms.
- Kian Abouhossein, of JPMorgan Chase:
  - Expected revenue from the business about $11 billion
  - Average growth 9% -2010 through 2012
- Reason for the success of this particular desk is the explosive growth of ETF (Exchange traded funds)— an investment class that tracks indexes or baskets of assets
- Increased demand from investors for computer program trading, which uses mathematical models to execute lightning-fast transactions

ETF is high risk

- Terry smith CEO of Tullet Prebon, on ETF:
  - “The risks that are being incurred in running, constructing, trading and holding them are not sufficiently understood.

    After the UBS incident I think this should be regarded as indisputable."

UBS ad for Delta one trader!

- A minimum of five years' equity trading experience
- A Master's degree in financial engineering, statistics, maths or information systems,
- And experience with quantitative trading

Return on equity in Delta One operation

- Societe Generale: Over 100%
- Goldman Sachs: 52%
- UBS : 72%
  - JP Morgan report
    - *Isn’t it obvious something is wrong here?!*

What possibly happened?

- A. An extraordinary mistake which saw Adoboli buying Swiss francs to hedge a position when he meant to sell them. This left him with a huge exposure to the currency, and when the Swiss National Bank recently intervened to lower the value of its currency, (It is pegged at 1 Euro is 1.2 CHF to stem the runaway strengthening of Swiss francs) he was exposed to huge losses.
- B. The losses could have also resulted from a trade on a behalf of a client, in which case the bank would have taken the other side of the trade.
  - But the bank may have mistakenly allowed its position to grow excessively, or failed to hedge it. Or
  - The bank could have decided to hold on to the position after making the trade for the client, thereby putting its own money at risk
- C. Another possibility:
  - Loss tied to the volatility in European stocks, a result of worries that Greece could default. It is possible that Adoboli picked the wrong time to either bet that a European stock index would rise or fall and that an ETF was used in the trade.

What possibly happened? Contd.

- D. Yet another possibility:
  - He was booking trades, which should have been flagged, then apparently reversed them with fictitious trades, so they weren't picked up.
  - Real positions may have been hedged with fictitious trades. If these trades had forward settlement dates, they would not have failed yet.

Possible reasons why it happens

- Best traders move to hedge funds and banks are left with rogue traders
- After down sizing there are not enough people to physically check things
- Too much reliance on computer systems which can be by-passed
- Culture of trading room is itself high risk taking
- The drive to make money is intense
- There is a bullying atmosphere in the room
- Ex back-office staff are called ‘jub’ (Junior Jobsworth) and face higher pressure to justify their place
- Back office experience helps rogue traders knowing how to circumvent the systems
- Oswald Grubel the CEO himself kept advocating an increase in risk-taking from Mar 09
- As they make BIG money there is no will to probe the activities of the traders
- Minor incidences are not taken note of and not publicized

The questions

- "Why did the systems not spot this before it got totally out of control? … he must have found a way round the systems to get this far into debt.“-Chris Roebuck, Case business school
- What oversight the bank had on the trader’s Position?
- Whether the trader hid the risk from compliance officers? How?
- Is UBS case also like the Societe Generale case, where the gaps in security were obvious. The bank had risk management policies and controls to detect bad trades, but those policies and controls were not enforced, and security practices were lax?

The questions contd.

- Did UBS implement controls to detect and correct what are called "toxic combinations" - access authorizations that allow traders to bypass controls for segregation of duties controls?
- Was there in place a firewall between "casino“ investment bank and its retail arm?
- In 1998 after the $625m fraud in derivatives trading arm , UBS assured the world that it had "taken note of weak spots" that allowed the loss to come about! Was it a fact?

Impact

- Mr Adoboli's boss John Hughes resigned after news of the arrest
- A number of other members of the desk suspended, pending questioning as to whether any were involved
- Financial Services Authority, the City regulator, is investigating why UBS did not identify the transactions.
- Moody's reviewing UBS's rating, focusing on "ongoing weaknesses" in the Swiss bank's risk management
- Could have personnel consequences at senior management level

Role of regulation

- Volcker rule (named after Paul A. Volcker, the former Federal Reserve chairman who proposed it) , under the Dodd-Frank overhaul of financial regulation, would prohibit Prop trading (Proprietary trading) , although the details of the rule are still being written
- But what constitutes proprietary trading can be fuzzy
- Wall Street consider prop trading, to involve only trades made by dedicated traders who are using the bank's capital and do not have access to client information.
- The trading done on Delta desks, they contend, is done on behalf of clients.
- Goldman Sachs and BOA have closed their prop trading operation- But Goldman Sachs has a larger Delta One business than UBS

Americans for financial reform

- Says of this problem :
  - “..once again highlights a central problem with our financial system — that the largest banks have grown so big and so complex that even their own management cannot fully understand or control the risks they take.”

The investigations

- David Sidwell an independent director is running the bank's own investigation
- Sidwell Former CFO JP Morgan -is going to find out the modus operandi of the fraud, why risk management systems failed and measures to be put in place
- Deloitte doing independent investigation on behalf of Authorities

The rogue traders gallery

- Jerome Kerviel, Societe Generale, Paris, 2008- $6Bn (The Big daddy of them all!)
- Yasuo Hamanaka, Sumitomo Corporation, Tokyo, 1996 - $2.6bn
- Nick Leeson , Barings Bank, Singapore, 1995 (The most famous of them all!) -$1.3bn
- Toshihide Iguchi, Daiwa Bank, New York, 1995- $1.1bn
- John Rusnak, Allfirst bank, Baltimore, 2002- $700m
- Joseph Jett, Kidder Peabody - $350m

Lessons from what we know!

- Should UBS have restricted the shift of back-office, technical personnel to the client-facing trading desk because of the risk of their exploiting their knowledge to manipulate trades? (Kerviel also came up through the back office)
- Should not very high returns make banks sit up and notice what's happening?
- UBS has been upgrading internal controls and risk management after taking write-downs of $US50 billion on toxic assets in the 2007-09 global financial crisis- were they too slow in doing this?
- Is ETF toxic like CDO? What is the next 3 letter equivalent toxic financial instrument of the future? Are all derivatives 'financial weapons of mass destruction'?
- There should be checks to see if real positions are hedged with fictitious trades with forward settlement dates. There should be very strict rules around long settlement contracts.

Lessons contd.

- The bank had a 44-page dress code for staff – was it controlling the wrong stuff?!

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