



See Who Rises to the Rogue's Hall of Fame



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Regulators should consider making this a mandatory reading 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, had top bosses learned from history and taken sufficient corrective actions at their financial institutions (FIs)? Had policy makers taken a strong enough stand to curb against speculative risks that have repeatedly brought the economy down to its knees? This is NOT a story about corporate governance and risk culture, but a showcase of how little the industry have learned from these rogue 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), why their voice weren't being heard, were they being bully or their qualified opinion 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 also be contained upon the first margin call/ warning signal, why headquarter management of this 233-year-old bank granted 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 approvers whom put up the money behind Leeson's one-sided risky bets indeed became the implicit endorsers to gamble on the bank's faith!!

Though 21 top executives at Barings were ousted when the organization crumbled, should the board and management face more severe consequences? Gross negligence, failed to establish compliance programs reasonably designed to ensure and monitor compliance, trade in excess of reasonably expected near term demands (RENTD) – all these would be considered prosecutable crimes if the Volcker requirements were effective back then.

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 rubbed-in to [Daniel Bouton](#)'s lip service about SocGen's internal control strengths by stating the followings in 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 can do 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 suspects on whether Kerviel did act alone (see [this](#)). SocGen's board and management could have acted upon any warnings much sooner, were they repeating the episode of Barings? Kerviel were using "hedges" as a convenience excuse. If the trades were under today's rule, it won't be qualified for the Volcker's hedging exemption.

Whenever fake trades were questioned, Kerviel was slick to cancel the trade followed by replacing the bet using a different instrument to avoid detection. [Modern surveillance technology](#) would have looked out for suspicious trade patterns and prompted for a timely review; but were SocGen management being "blindsided" back then? Well, as recent as 2016, CEO can shamelessly claim being "[blindsided as bank added to risky positions](#)" that attributed 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 trade process as a carousel for his unauthorized trades (see [this](#)). Hughes did not declare of such in the desk's profit and loss report, which led to his permanently disbar from working in finance. It was later discovered that UBS failed to act on a warning issued by its computer system. So, why computer warning wasn't appropriately follow-through? Why the two in the front-office would be 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 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 excess of risk limits 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, hence analyzes may be conducted on a play-by-play basis rather than letting things blurred-up by "net risk limit".

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

D. Bruno Iksil (a.k.a. [London Whale](#)) of JPMorgan Chase (JPMC) – \$6.2 billion loss in 2012

Claimed to have learned:

The U.K. Financial Conduct Authority abandoned a proposal to fine Iksil \$1.4 million and refrained from banning him from the industry. He had 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 awaited to be seen 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 cast their frustrations on this JPMC 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

As a background of this case, JPMC's Synthetic Credit Portfolio (SCP) increased tenfold in 2011, in early 2012 it tripled again to \$157 billion. The mandate for this SCP trading desk meant to be long-term hedges to reduce the bank's risk. In reality, the trades were compiled of over 100 synthetic derivatives, complex to unwind or no tangible way to stop losses. JPMC's Chief-Investment-Office (CIO) tried to finesse the problem ended up blowing up even more than their original bets. This case illustrates that price can fluctuate significantly in split second and proprietary trading can cause disastrous amount of trading losses and systemic risks to the markets.

Perplexing as the matter might be, an article by the [New Yorker](#) explained, "how did JPMC – a creator of the prominent Value-at-Risk (VaR) method for risk measurement – end up misusing its risk-measurement tool?!" To quote from another article on [Bloomberg](#), "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!!" [Exhibits](#) of 2013 Senate Hearing retained evidence of how massive losses were hid. Attempts to disregard risk as "tempest in teapot" and/or play down the wrongdoing 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 slicky practices have tarnished trustworthiness of banking sector to reliably access risks and provide accurate, timely, and complete information to the regulators.

Before jumping to the conclusion

It's easy to raise the banners about corporate governance and risk culture improvements. However, what good is it when top bosses may just be paying lip services or bragged about its control strengths as in the SocGen case?! Installing new people and/or adding several thousand pages on 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 compounded and pressures are heighten, would people still be acting on their best behaviors, or compromise to 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??

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 breaks loose – fictitious hedges will come back to haunt financial stability!

Details and Speed

Banks are like [alchemists](#) and devils may reside in the details. Without stitching details into bigger picture, one can only “guesstimate” how much is at-risk from these complex synthetic trades. Thus, a “play-by-play” instrument approach to securities inventory is essential for electronic audit. So regulators should 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. Risk intelligence is critical in stopping losses timely. In preventing institutions from digging into deeper holes, warnings must be duly acted upon, or else there should be automatic triggers to notify regulators for effective enforcement. The end-to-end processes would be digitized to ensure regulators won’t be dodged from asking for more details, or data will be speaking for itself to minimize intrusion. What had been the concrete improvements to address the modern-day financial engineering challenges (e.g. [clock synch](#))? I think the industry still has a long way to learn.

Rogue’s Hall of Fame

Rogue of all rogues is hard to identify. He/she may appear as slacker to foster a weak control environment. He/she can also be so slick to induce others into wrongdoing while running crimes behind the scenes. Imagine if top rogues willfully disregard warnings or intentionally delay curbing of violations – these could be their implicit endorsements to impermissible behaviors. If risky bets resulted in money gain, they’ll win big and pamper their subordinates with bonuses, salary raise, or promotion. When things turn bad, top rogues may selectively allow their favorites to conceal small losses while quietly dismiss one or two whom unwilling to collude.

I may be speculating about the extremes and imaginary rogues in here, but evil plots and fraud collusion aren’t anything new in the financial service industry. Investigation and detection are always difficult, yet control functions may consist of sloppy people having [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 on 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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