

## Let's have 'ethical rogue traders'

Planting a few of them in the dealing room could be just the acid test that trading systems in banks like UBS need. By Paul Aldrich and Pete Metzger



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IF THERE is one quote that Oswald Grübel, UBS's former chief executive, won't live down even after his resignation, it is 'risk is our business'. He told Bloomberg last November: 'I can assure you, as long as I'm here, as long as my colleagues are here, we do know about risks.'

UBS management couldn't have known of their US\$2.9 billion risk when they hired Kwaku Adoboli in 2006, regardless of how strictly due diligence was imposed during the recruitment stage. And never mind that Grübel imposed new risk controls and sent traders instructions not to lose money, after joining UBS as chief in 2009. UBS's internal controls were apparently even unaware of the enormous losses by Adoboli until he confessed.

Unfortunately, Adoboli's timing could not have been worse for UBS, which lost over US\$50 billion during the global financial crisis. It also provoked questions regarding the banking sector as a whole, coming as it did in the midst of a crisis of confidence in Greece and other European sovereign nations.

However, a couple of things are worth remembering.

Firstly, classic investment banking is an advisory business that in itself does not involve financial risk but which may lead to certain banks accepting underwriting risk. For instance, investment banks such as Goldman Sachs underwrite some capital market transactions but advisory firms such as Rothschild and Lazard do not.

Secondly, the secondary market activity in Equity and the FICC (fixed income clearing corporation) asset classes facilitate wholesale and retail transactions for entities

including institutional and retail investors, sovereigns, supranationals, banks and corporates as well as individuals. Given the volume of legitimate trading undertaken globally in dealing rooms around the world, losses incurred by individuals are clearly exceptions.

At a macro level, regulators are seeking to ensure that banks are secure and in future will not need to be rescued by tax payers, for instance: in the UK the Vickers report seeks to ring-fence the retail activities of large banking groups, such as Barclays, from their investment banking and trading activities; the Volcker legislation in the US seeks to ensure banking groups are not taking proprietary risk and are solely focused on market-making and client-driven trading; and, increasingly stringent, Basel capital requirements seek to ensure that the capital held against trading, and other bank activities, are commensurate with the assessed risk of each position.

To be fair, banks, like all organisations, face certain risks in undertaking their activities. One just needs to recall the collapse of Enron or BP's Deepwater Horizon oil spill disaster. But unlike many sectors, banks can suffer significant losses from the actions of one individual or a relatively small part of their operations.

To mitigate such risk, banks already have new business and new product committees, middle and back-office processing and analysis, risk management functions, and both external audit and internal audits. Fraud and billion-dollar losses don't have to occur and cause a stir if risks are properly understood, robust processes are established and individuals are made to work strictly within appropriately set processes and risk limits.

While headlines about 'rogue' bankers working in 'casino' banks make great news, they do not reflect reality. Given the volume of trading undertaken globally in dealing rooms around the world today, losses incurred by individuals are clearly exceptions.

A number of the most high-profile instances have been

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due to the actions of traders who had previously worked in the middle-office, which supported the trading activity. It has therefore been suggested that a career path from back/middle-office to front-office should not be open. However, this is missing the point.

The problem is that most banks often don't think and plan like rogue traders. The complexity of modern banking takes day-to-day risk management beyond the ability of even the most experienced management teams.

With regard to UBS, questions are obviously being asked as to why the revamped risk management environment was not able to highlight the activity of Adoboli.

Another question should be whether the chief risk officer, chief information security officer (CISO) and chief operating officer were coordinating their efforts to prevent losses from fraudulent trading activity. Many enterprises are already attempting to converge information security, risk management and compliance into a single entity that is responsible not only to the CEO, but also the board. Some are taking the progressive view that risk management executives should have a direct line to the board for certain matters. Indeed, the role of the CISO has evolved over the past five years from one of IT security administration to high-level risk management.

Additionally, it has been reported that banks such as Citi and clearing houses such as the Depository Trust & Clearing Corporation (DTCC) are employing 'ethical hackers', who report to the CISOs, to attack their payments and other systems.

One could also ask, therefore, why banks shouldn't consider employing 'ethical rogue traders' to attack their own trading systems? To follow through on this, banks need to decide on some critical factors such as the objectives and terms of engagement; whether they should use independent consultants or their own staff; and who they will be accountable to.

The unauthorised position taking of Adoboli at UBS cost shareholders US\$2.3 billion as well as the jobs of Oswald Grübel and others, including the two co-heads of global equities. We may yet see a significant reduction in the trading and investment banking activity undertaken by UBS.

Maybe it is time for banks like UBS to also consider testing their own systems by giving 'ethical rogue traders' a seat in the dealing room. That could be just the acid test that trading systems in banks need.

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