The recent news that an apparent ‘rogue trader’ at Swiss bank UBS had triggered losses of £1.5bn sent shivers through the banking community. Rogue traders can rack up catastrophic losses, as Jérôme Kerviel at Société Générale and Nick Leeson at Barings showed.

What keeps bankers awake at night is that, despite the renewed focus on risk management and internal audit after each incident, rogue traders keep cropping up. Is rogue trading endemic in high-risk financial trading or can a system be designed that delivers the profits but deters the rogues?

After the most recent alleged incident, involving London-based trader Kweku Adoboli, UBS announced an internal enquiry to be conducted by KPMG. But many other banks will also be taking a closer look at their risk management, trading processes and auditing procedures.

So what is going to come under the spotlight? And how might this affect finance professionals working in banks?

Three main areas are likely to be the focus of attention: whether the right people are being recruited into financial trading, whether processes and systems and their audit controls are adequate, and whether the culture of investment banking should be modified.

People

Rogue trading is often committed by people who move into the front-office from the back- or middle-office, says Philip Molyneux, professor of banking and finance at Bangor University. ‘They know about the mechanics of the back-office and have the skill to circumvent systems fraudulently,’ he says. ‘They tend not to be high-fliers. They’re doing relatively modest trades but they start losing money. Then, to save face or their job, they start undertaking fraudulent activity on a small scale to cover up their problems. The problems accelerate and they have to run faster to cover up the losses. These escalate until they get so large that the fraud is uncovered.’

Molyneux argues that rogue traders tend to become psychologically attuned to their crimes. ‘They become deluded and think it’s normal practice. The problem is that investment banking can attract people who are willing to undertake illegal activity to cover up losses to save their face.’

Adrian Kinnersely, managing director at Twenty Recruitment, says: ‘I wouldn’t be surprised if, at some point, there will be regulatory controls to stop back- and middle-office people being promoted to the front-office at the same bank. This could have a significant knock-on effect for juniors joining banks in back- and middle-office finance roles with the dream of becoming the next Gordon Gecko.’

But Alastair Goddin, head of risk management at Omega Insurance and a member of ACCA’s Financial Services Network Panel, doesn’t think that stopping back-office people from working in the front office would deter rogue trading.

‘For starters, it assumes people will put all relevant experience on their CVs when changing roles and that people in the front-office don’t have friends or family in back-office roles,’ he says. ‘In general, preventing people from doing certain things by trying to ensure they don’t know how to do them is a weak control – people have a tendency to work things out if they want to.’

Processes

Beyond the recruitment question lies the issue of making processes and procedures robust enough to thwart the most determined rogue trader.

John Webb, an independent risk management consultant, certified fraud examiner and member of ACCA’s Internal Audit Network Panel, identifies three lines of defence. The first is ‘strong and consistent management vigilance at the dealing desk level’.

This defence can be ‘massively strengthened’ at the second line, with risk management and product control. Each trader’s P&L should be reported independently every day, Webb argues.

His third line is internal audit, which he believes should act as an objective and independent review function that recommends control improvements.

He says: ‘One of the many questions now posed is how long the prices
advised by traders can be relied on before being independently verified at the second line of defence. So soon after the credit crisis, we really do need to get these fundamentals right.’

David Sherriff, chief executive of banking software provider Microgen, says most banks have implemented risk controls in line with the Basel II and Sarbanes-Oxley regulations. But he adds: ‘The complexity of systems and the spaghetti nature of ageing IT architectures inevitably mean there are manual workrounds for emergencies.’

Manual intervention, user-driven systems and complex integration all create opportunities for fraud. Sherriff says: ‘Banks should be looking at improving the quality and availability of data, particularly within the finance and risk operations. It’s important that risk data acquisition and analysis is simplified through more automated and robust mechanisms.’

Culture
But can even the strongest processes backed by the most comprehensive auditing procedures catch every rogue trade if the culture in the bank encourages excessive risk taking?

Molyneux says one of the challenges is the aggressively competitive deal-making culture. ‘When there are people who have positions that may be short tenure if they don’t perform well, there is an incentive that a rotten apple will undertake fraudulent activity.’

Goddin argues that culture and structure are intertwined: ‘The risk of someone performing fraudulent acts is greater when they are left to their own devices in a big team environment. Small tightly knit teams are more likely to be aware of one individual’s personal circumstances and behaviour.’

Paul Moxey, head of corporate governance and risk management at ACCA, believes a shift in culture is vital in solving the rogue trader problem. He says: ‘In most organisations, people get some satisfaction from their work beyond the money they earn. But if you’re working in a bank trading culture, there’s no intrinsic value to society. The amount of money you make is your fixation. Anything goes as long as it’s making money and it’s within compliance. So traders sail as close to the wind as they can, but sometimes they go too close.’

In the past, the problem has been compounded because banks know the government will bail them out. The Vickers’ Independent Commission on Banking proposals, which the government has committed to implementing, may nudge the culture in a more responsible direction. But it won’t dramatically change its direction.

So can the banks themselves do so? Molyneux says: ‘It’s likely there will be more checks and balances internally, greater scrutiny of potential areas for operation, possibly much more scrutiny of people moving from front- to back-office, but I don’t think it will change the culture.

‘We’ve had these cases of rogue trading before, but the culture of the investment banking business is much as it was 30 years ago.’

Peter Bartram, journalist