Beyond limits

WHAT DOES A ROGUE TRADER LOOK LIKE AND HOW CAN YOU PROTECT YOUR ORGANISATION AGAINST THEM? SCOTT RAEBURN EXPLAINS HOW THEY OPERATE AND HOW TO SPOT ONE

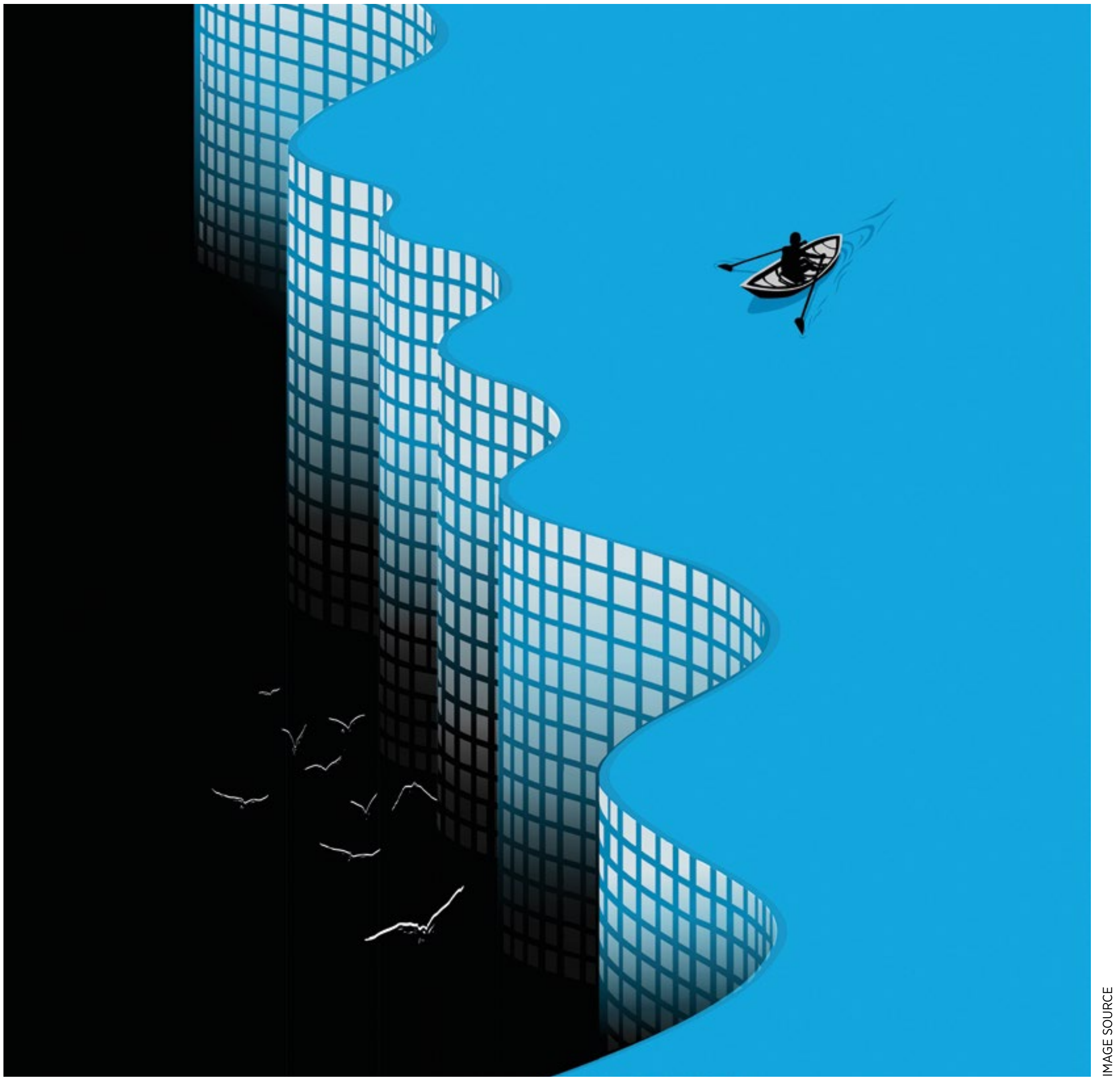

IMAGE SOURCE

What do we think of when we hear the term 'rogue trading'? Footage of a youngish bank trader making massive losses with a few reckless, fraudulently entered trades being dragged before the courts on the evening news? That's a simple and familiar image, but comfortably far removed from anything to do with our business, surely.

Unfortunately, it's not quite that neat and straightforward. We hear about rogue trading when it's big and goes spectacularly wrong, such as in the famous ones (see the box on page 37). That is when it's too late to do anything and the ensuring events become a spectacle. The more interesting questions for treasury professionals are around the cases we haven't heard about yet.

So, what is a rogue trade? It's not an unprofitable trade, or an undeclared one, or even an unwise one. It is simply an unauthorised trade. These are not trades carried out by people who shouldn't be trading, but those with access to trading mechanisms who are breaking the rules around scale, risk or the instruments they are allowed to use. A rogue trader is someone in a position of trust misusing it, then concealing their actions – rather like a spy does.

The rogue trades that are most often reported occur in banks, because the scale and impact is often dramatic and newsworthy. But these abuses can happen anywhere there is trading in play – commodity and FX markets would be the most likely contexts for corporates. More complex and leveraged instruments can magnify the scale and help conceal the true underlying risks. But a simple spot deal could actually be rogue, depending on the reasons it was placed. Even refraining from making a trade that policy would indicate the need for might, strictly speaking, put an individual outside the rules.

What motivates somebody to be a rogue trader?

To continue the spy analogy, espionage recruiters look for one or more of four classic behavioural drivers to induce insiders to act against their own organisations. Collectively, these attributes go by the acronym MICE:

Money, while the simplest motivation, is often not the stated issue here. Rogues often say they make 'no personal gain' from their activities, beyond bonuses at least. To an outsider, these are relatively modest compared to the career risks being run by people supposedly expert in assessing the value of risk.

Ideology could be a possible motivator, where the trader fundamentally disagrees with the policy they seek to circumvent. The individual feels the need to prove their correctness in the irrefutable arena of market success.

Conscience is surprisingly common as a partial reason at least for rogue trading. The rogue trader justifies their action as being for the good of the employer, particularly when bending trading rules to recover losses. Partly, that's also a desire to avoid trouble, but the individual often convinces themselves they are acting out of loyalty.

Ego plays a large part. An inability to admit to error and an insistence that reality conforms to one's needs and expectations – these are not just the preserve of the amateur small investor.

And what sort of setting might unwittingly encourage rogue trading? If official policy is zero-risk tolerance, but active trading can result in rewards like recognition, promotion or bonuses... then rogue trading is more likely to occur.

Perhaps the worst thing that can happen is when a first-time rogue trader meets with early success – the trading behaviour pays off and they manage to cover their tracks, so the behaviour is reinforced and encouraged. As for those alleged cases where managers were aware of and tolerated off-the-books trading because of the results, it stops being clear who is the rules-breaking rogue and who is merely inputting the trades.

A culture that does not address the possible motives behind rogue trading allows them to build up. If a junior trader can't question the reasoning for a policy and expect a reasoned answer, sooner or later somebody will try their own experiment. If only those with unconventional results get recognition or reward, then everyone will be seeking to emulate them. Similarly, a culture that doesn't tolerate admissions of failure will tend to have problems.

Rogue trading often draws in others. The rogue trader has to put time and effort into concealing their actions and that may involve others – other traders or accountancy staff to amend the records. In the case of Toshihide Iguchi (see box, below), it was the stress of concealment that eventually led to him coming forwards, after 12 years of clandestine trading activity.

While rogue trades are hidden from others within the organisation, they're not out of sight from counterparties – settlement will eventually become necessary and, when this is a loss, an organisation's liquidity risk is heightened. Nick Leeson (see box, below) might have continued for years if his authorised overnight position hadn't suddenly been revalued by the Kobe earthquake.

What to do if you're a rogue trader? If you're ahead, walk away now. Has it really been worth it? If you're in trouble, is it really fair to your firm and colleagues to take even greater risks to bail you out? Coming forward takes courage, but may allow for a more controlled solution for your employer. On a more self-interested note, it might conceivably improve your legal position.

How to spot rogue traders

If a rogue trader comes to light in your organisation, remember they know the actual situation fully and will be best placed to shed light on it, help resolve it and perhaps even improve controls to avoid reoccurrence.

Whether the culprit is you or someone else, there are two key tasks. The first is assessing the positions and resolving them with the least disruption possible to business health and activity. The second is dealing with the possibility of other rogue traders in the organisation by improving controls and auditing all activity thoroughly, ideally with the assistance of somebody who knows how to bypass the controls. Consider allowing a very short amnesty period for others to come forward.

If you're tempted to place a trade outside your firm's rules, examine your reasons. If the trade would be in the organisation's best interests, but outside its current rules, make your case openly, propose some policy amendments or get the reasons you don't yet know for why the policy makes sense.

If you've not got any good reasons for the trade, or are unwilling to voice them, then prepare to become a rogue trader. And remember, all you need to do is have the Great Humbler (also known as the market) react with the values and timings you want for every trade. But that should be easy... the rules don't apply to you, do they?

DANGER SIGNS

APPARENT DILIGENCE The rogue trader is always in first to amend overnight reports in private and often never takes holidays, as they can't risk giveaway signs coming to light in their absence.

UNEXPLAINED PROFITS OR LOSSES Some rogue traders deliberately create losing positions to offset and disguise excess profits.

CONSISTENT PROFITS or trading results, especially if they coincide with the reaching of targets. Very few people in the market are lucky all the time; those who are tend to celebrate it.

EDITED, DESTROYED OR LOST trading records might hide rogue activity, but a read-only, or activity-logged duplicate of all trades entered into at a secondary location would be harder to tamper with.

FAMOUS ROGUE TRADERS

Name	Organisation	Instrument used	Value lost	Time as rogue
Jérôme Kerviel	Société Générale	Index futures	$6.9bn	2006-2008
Yasuo Hamanaka	Sumitomo Corp	Copper	$2.6bn	'years' to 1996
Kweku Adoboli	UBS	Stock futures	$2.3bn	2008-2011
Nick Leeson	Barings	Index futures	$1.3bn	1992-1995
Toshihide Iguchi	Resona Holdings	Treasury bonds	$1.1bn	1983-1995

Scott Raeburn is a treasury professional in the industrial manufacturing sector