Is Rogue Trader Taking a Fall for Corrupt UBS?

Swiss bank UBS trader Kweku Adoboli (left) was arrested early Thursday morning and charged with two counts of false accounting and one count of "suspicion of fraud by abuse of position." His position was director of the Delta One trading desk at UBS in London, where he had worked as a trader for the past three years and as a technical advisor for two years before that.

The desk specializes in Exchange Traded Funds (ETFs) which allow investors to take a position in an index without having to purchase each stock represented by that index. Trades were profitable when positions were taken that move higher (long) and the index rises, or that move lower (short) and the index declines. Adoboli had learned the system well, and he lived well, paying $1,570 a week for an apartment in a high-end neighborhood just five minutes' walking distance from his office.

But something went wrong — terribly wrong — when the Swiss Central Bank announced on September 8 that it would not allow the Swiss franc to rise beyond a certain level versus the euro. The mere whiff of intervention caused the Swiss franc to swoon by more than eight percent in two days. Speculation abounds that Adoboli had taken a position that anticipated a continuing rise in the Swiss franc, and had compounded that position with leverage, thus allowing any move upward by the franc to be multiplied significantly — and profitably — in his position. The risk to such a position is that a "black swan" event, such as the announced Swiss intervention, could turn that leverage against his position. Although UBS is keeping silent about the details, those close to the Delta One desk (one of whom resigned immediately, and two others of whom were suspended by the bank) say it is possible that the position cost the bank many millions, perhaps as much as the $2 billion noted in various press releases on Friday.

Immediately there were questions. The first is, how did the trade go so badly? Delta One is a measure of risk — modest, controllable, measurable, conservative — and the Delta One desk wasn't supposed to be taking excessive risks. Part of the answer is that Adoboli was using "synthetic ETFs" — a knockoff of regular ETFs that allowed much higher leverage through the use of options. When his trade went against him, Adoboli knew he was in trouble, writing on his Facebook page a few days earlier that he "need[ed] a miracle" to cover his position profitably.

The second question was raised by Fred Ponzo, a former trader at Societe Generale, who asserted, "The thing is, it's very hard to go through the fail-safes [risk management safeguards] by error. The only way to dig a hole this big is by design. You have to ask the question that if this is a $2 billion hole, is it the failure of technology or risk management?"

A "rogue trader" is, according to Julia Felsenthal, "someone who makes trades that haven't been authorized. Every trader is allowed to take on a certain amount of risk, and if he wants to exceed that value he must get the permission of his supervisors." She explained:

> Traders are said to have gone rogue when they've either made investments that are too risky, or invested much more money than they're supposed to.
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> In some cases, unauthorized trading leads to profits, in which case it's less likely to be contested. When it results in a loss, traders often end up having to go even more rogue, doubling down to get out of the red. This can lead to other types of fraud.

Another question arises, however, when the charges against Adoboli are found to go back to October of 2008. Analysts are asking how it is possible that his supervisors were unaware of his behavior *for three years* before his arrest. It's especially peculiar when UBS had just discovered shortages in its mortgage lending operations which were so massive that they had to be bailed out by the Swiss government. The CEO was replaced at the time with a new one, a "watchdog" named Oswald Gruebel, who was committed to improving internal risk management procedures in order to gain back some market share and the bank's credibility which had been so badly damaged.

UBS has a recent history of risk management "failures." Its Dillon Read Capital Management hedge fund lost 150 million Swiss francs in the first quarter of 2007, and as its subprime losses spread to the investment bank of UBS, CEO Peter Wuffli, chief finance officer Clive Standish, investment bank chief Huw Jenkins, and chairman Marcel Ospel all hastily left the firm. Losses were so large that its capital was severely impaired and UBS had to be rescued by the Swiss government. Also in 2007 another rogue trader at the French bank Societe Generale, Jerome Kerviel, had a trade implode to the tune of $7 billion, and so UBS was, or should have been, on high alert.

The impact of Adoboli's trading losses is likely to have a significant impact on UBS. The bank's honorary chairman Nikolaus Senn said in an interview on Saturday that Oswald Gruebel "wouldn't be able to remain as CEO because of the losses. UBS lacked adequate controls." Regulatory agencies in both the UK and Switzerland have announced a joint investigation into the matter. And Moody's is looking to do a downgrade of the bank as well "because of ongoing weaknesses that have become evident again by the events leading" to the trading losses.

The *UK Daily Mail* wasn't going to let UBS get away with putting the blame solely on Adoboli, indicating that the event "points to more deeply rooted problems at an institution that took a $60 billion hit in the US sub-prime property crash," adding,

> That the London rogue was allowed to cover [his] tracks until [his] losses all but smacked [his] supervisors in the face points to a level of corporate dysfunction far beyond the bank's badly-judged bets on US trailer-park loans.

As Anthony Wile speculated, "banks such as UBS encourage 'rogue trading' because essentially there is no penalty for the larger institution. Rogue trading never seems to emerge when banks *make* money, only when banks lose it." [Emphasis in original.] He added,

> The bottom line is this: [T]oday's world of "financialism" encourages excessive risk taking and extreme leverage. In fact, while the banks maintain an outward illusion of conservative practices, their internal policies are anything but. [Kweku Adoboli] is just another example of a trader being thrown under the bus in order to protect the bank's image. Adoboli will be victimized, yet he was no doubt doing exactly what he was enabled to do. The whole system is built on leverage.

Adoboli is likely going to jail. Presumably Gruebel will be retired. UBS will no doubt absorb the loss. The regulators will have little impact on the bank's operations. It is probable that UBS will continue to rely on the absence of "moral hazard" in its investment and speculation activities. In other words, nothing is likely to change.

Photo: Alleged renegade UBS trader Kweku Adoboli, center, walks to a security van flanked by police officers after appearing at the City of London Magistrates Court in London, Sept. 16, 2011.: AP Images