Rogue trader or rogue culture?

Six weeks after JP Morgan announced that Bruno Iksil, a rogue trader known as the 'London Whale', had incurred losses of $2bn, it transpires that this will be at least $5bn and could be as much as $9bn. If the higher figure is realised, it will eclipse the previous record loss of $7bn held by Jerome Kievel at Soc Gen in 2008 (which had dwarfed the earlier Nick Leeson loss of £827m at Barings in 1995).

What does this tell us about risk assessment and when the value-at-risk to JP Morgan was originally put at $70m and the value of the bank itself has been reduced by $35bn in the past two months. How was this figure calculated, did the risk assessor in question really have all the information necessary?

According to US sources, JP Morgan's head of risk who oversaw the department that made the losses, had been fired from a rival bank for "gross mismanagement of risk" in 2007, yet he was taken on by JP Morgan in February 2012. Does this mean the HR function at JP Morgan failed to check references carefully, or does it mean the bank has a cavalier attitude to risk within corporate governance?

How does risk control work in an Investment bank? The bank seeks out risk to earn money from trading, yet is obliged to field a risk function as part of its regulator compliance. There is an implicit disconnect between the appetite for risk of a trader at an investment bank and its Chief Risk Officer. The risk assessor must reconcile the risk appetite of a trader with the risk appetite of the bank itself to set parameters for operation on the trading floor. Is this realistic, especially if even the trader's own line managers don't know exact details of his position?

Let's look at the lessons of the three individual cases, Leeson, Kievel and Iksil to see if they really were rogues or merely unlucky, being in the wrong place and the wrong time. All traders make some losses and these contribute to their on-the-job experience, but the positions some take in trying to recover losses, put the whole trading floor in jeopardy. The basic rules of risk assessment and risk control become compromised in high risk trading positions.

Why do banks repeatedly take such dangerously large positions? It is axiomatic that high reward only comes with high risk, so how have investment banks for so long managed to convince regulators that their risk controls are adequate? As Reuters reported in May 2012 : *'The short answer is over-confidence among the bank's traders and managers, coupled with a failure of proper systems and controls'*. To put it simply: hubris and complacency.

Let's consider our three 'rogues': each trader was insufficiently supervised, partly because trading is a very personal perspective on future price movement, and partly because each had been successful at making substantial amounts for their respective firms so were trusted to make more. Each had got into a situation where if things went right they would make a fortune, but if things went wrong the consequences were disastrous. As individuals none would want the scale of risk to be known to the firm for fear of justifiable censure.

In Leeson's case it was the Kobe earthquake that undid his position, a Black Swan event which made his position untenable and bankrupted Barings. In Kievel's case he manipulated the system and managed to hide his losses for almost two years until the internal audit people finally caught up with him. Were they slow or was he just good at evading scrutiny? In the case of the Whale, he was known to take positions of very high risk but had previously made the bank millions, the risk assessment of his final exposure was clearly inadequate.

What lessons can be learnt? As a bank if you don't know how your traders make high returns for your firm, then you mustn't be surprised at their ability to make huge losses. In all three cases of rogue trading evidence subsequently emerged that management didn't understand the products that were being traded. Behaviour of the individual traders in question was not exceptional in their industry, but the size of their respective losses was, so in each case management heads had to roll. The culture is more to blame than the traders themselves: if your currency is high reward then you must expect high risk, it comes with the territory.

Prof Garry Honey founded CHIRON (www.chiron.uk.net) to explore reputation risk.