The Financial Psychopath Next Door

Rogue traders are disturbingly common

KEY POINTS

- Traders tend to be overconfident in their skills and ability to influence the outcome of events; in extreme cases, they can become compulsive gamblers.
- Extreme risk takers are often in deep trouble by the time they become aware of their behavior.
- Financial firms need to do a better job of screening job candidates and could consider using analytics technology to monitor employees' activities.

BY SHERREE DECOVNY

Modern investment theory is based on the premise that individuals are rational in their approach to financial decision making. Their key objective is to maximize wealth, and they are unbiased in their expectations regarding the future and always act in their own best interests. In reality, individuals sometimes make irrational decisions influenced by mental processes and emotional factors.

Traders in particular tend to be overconfident in their skills and their ability to influence the outcome of uncontrollable events, according to Victor Ricciardi, assistant professor of financial management at Goucher College and a specialist in behavioral finance. Traders often go through a period of time without any losses, and they convince themselves that the winning streak will continue. In gambling parlance, this behavior is known as "the hot hand fallacy." Interestingly, they are more apt to take profits than realize losses because losses affect their compensation, discredit them in front of their colleagues or can even cost them their job.

Taken to the extreme, some traders become compulsive gamblers. The behavior is often latent—neither they nor anyone else knows they have this propensity. They hide small losses and keep doubling their position to try to eliminate them. When those trades turn sour, they dig themselves into a deeper hole and deny any wrongdoing or failure. They rationalize by telling themselves that poor investment decisions are an occupational hazard. They lie to family members or others to conceal the extent of their involvement with gambling and commit forgery, fraud, theft, and embezzlement to support their habit.

Christopher Bayer is a psychologist who provides therapy to Wall Street professionals. He believes compulsive gamblers fight depression by gambling. Their actions give them a sense of power, control, invincibility, and grandiosity. They are attracted by the rush or high caused by increased levels of neurotransmitters such as serotonin and endorphins, in their brains. Compulsive gamblers are not motivated by financial gain. They want to lose, and they brag about their losses.

"People who have the most status in Gamblers Anonymous are those who have lost millions of dollars," he says. "The people who are the $2 horse players are considered chumps. It's a whole status system."

These "financial psychopaths" generally lack empathy and interest in what other people feel or think. At the same time, they display an abundance of charm, charisma, intelligence, credentials, an unparalleled capacity for lying, fabrication, and manipulation, and a drive for thrill seeking.

A financial psychopath can present as a perfect well-rounded job candidate, CEO, manager, co-worker, and team member because their destructive characteristics are practically invisible. They flourish in fast-paced industries and are experts in taking advantage of company systems and processes as well as exploiting communication weaknesses and promoting interpersonal conflicts.

Studies conducted by Canadian forensic psychologist Robert Hare indicate that about 1 percent of the general population can be categorized as psychopathic, but the prevalence rate in the financial services industry is 10 percent. And Christopher Bayer believes, based on his experience, that the rate is higher.

Yet these personality traits present a dilemma, adds Richard Peterson, managing partner of MarketPsych, which does psychological and behavioral finance training for portfolio managers, analysts, and financial advisors.

"You wouldn't want to hire somebody who doesn't have many of these traits because it's a competitive business," he says. "You don't want to spend time moping about employees you have to lay off. You just have to lay people off and keep going."

Extreme risk taking/compulsive gambling is an addiction, and the first step to recovery is recognizing that a problem exists and that emotions impact behavior. An addict's confidence and ethics gradually erode to a point where the rules no longer apply.

"This is happening unconsciously to most people," says Peterson. "By the time they become conscious again, they're in trouble—they've lost their job or maybe they're even in prison. It's too late."

One of Christopher Bayer's patients ran through his trading account on the New York Mercantile Exchange, gambling to the amount of more than US$2.5 million.

"It became quickly evident that this individual had no respect for money and he did not 'honor' his labor in making it. He was absolutely self-defeating," explains Bayer. "Professionally, my patient was an exceptionally gifted and talented trader, yet he was incorrigible, immature, and utterly irresponsible and just could never keep pace with his losses."

Compulsive gamblers can get help though 12-step programs, psychotropic medications, and psychotherapy. In this particular case, Bayer used books, poetry, and other materials to help foster relationships and increase awareness with this patient. Through historical research, the patient gained respect for the value of money and his "place in history as a trader." They also explored the need to hedge and protect his trades and build in a stop-loss model that had to be applied on every trade. The patient slowly dug himself out of the hole, but he will wrestle with a demon for the rest of his life.

An Ounce of Prevention

Ultimately, financial firms need to do a better job of screening job candidates. Their goal should be to hire people with good morals who are not obsessed with money and have interests outside of work. In addition to finding out whether candidates can build a financial model, employers need to get a feel for who candidates are as people. What do they do when they are out of the office? What do they value and believe in? What does money mean to them, and how do they perceive it?

Peterson advises firms to explore a job candidate's propensity for extreme risk taking by presenting scenarios. During the interview, candidates should be asked what they would do if their model continued to lose money over a period of months.

"You create a series of psychological dilemmas for people and see how deep they'll dig that hole," says Peterson. "You gradually escalate severity to see how they respond. In the end, it has to get more and more uncomfortable."

Given the high stakes, firms need rigorous risk management controls and sophisticated analytics systems that can track employees' activities and uncover potential threats. This is a data-integration challenge. Traders use multiple platforms, including order management systems, e-mail, and telephone. Each has a different information flow and format, and they are distributed throughout the firm but not connected.

"You're talking about thousands of different applications and dozens of different systems," says Eli Bingham, forward-deployed engineer at Palantir, a technology company specializing in analytics. "One statistic I've heard is that the typical financial institution has one database for every eight employees."

Employees have access to particular applications, and they have certain privileges on them. Typically, traders have access to front-office features and functionality but not back-office features and functionality. Sometimes exceptions are granted, however, giving them access to both. The infamous rogue traders at UBS, Société Générale, and Barings understood the front-office and back-office procedures. Because they had access to both sets of systems, they could cover their tracks.

Firms such as JPMorgan use services such as Palantir to scrub through toxic accommodations where access to systems can present a risk to the organization. The system uses integrated data and analysis tools to allow an investigator to cross data sets, examine activity, and reveal suspicious employee behavior. It models an employee's behavior across all the different platforms and looks for deviations from the norm. Firms also can monitor when privileges become available to particular employees and detect anomalies within a population of employees that have more privileges. The system also can be used to monitor for intellectual property theft, data leakage, and malware.

In the past several years, reckless gambling and rogue trading have led to large financial losses, damage to reputations, and (in one case—see sidebar) the complete collapse of the institution. Financial institutions are well aware of the threat, especially from employees that have intimate knowledge of and access to front- and back-office systems. Mitigating the risk should be a top priority of CIOs and other senior executives. At the same time, employees also should be aware of this occupational hazard, check their own behavior, and get help before it is too late.

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INFAMOUS ROGUES

In September 2011, UBS announced it had lost US$2.3 billion due to rogue trading by 31-year-old Kweku Adoboli, a director of exchange-traded funds at the bank. Adoboli had entered into legitimate transactions but then entered fictitious hedges against them into UBS's risk management system, thus breaching his risk limits. Having worked in the bank's back office, his intimate knowledge of the systems allowed him to keep his activities a secret.

In 2008, 31-year-old Jerome Kerviel lost US$6.7 billion through unauthorized dealing at Société Générale. He claimed the bank knew of his activities, but they did nothing to stop it as long as he was making money. His managers denied the allegation. Kerviel was first hired as a back-office employee in 2000.

In 1995, Nick Leeson infamously brought down Barings Bank with £830 million in bad trades. Like Adoboli and Kerviel, Leeson was a back-office pro. During his stint in Singapore, he was functioning as general manager, head trader, and head of the back office. In published accounts, he was described as an accomplished liar adept at falsifying records, and fabricating letters and stories to deflect questions from management, auditors, and representatives of SIMEX.

RECOMMENDED RESOURCES

"Déjà Vu All Over Again: Wishing won't make the recurring rogue trader problem go away" *CFA Magazine* (May/June 2008) (cfapubs.org)