Deutsche could be tip of the iceberg

By Paul J Davies

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It is not yet clear what role Anshul "Rusty" Rustagi played in the suspected £30m overstatement of his trading position that is the subject of an internal inquiry at Deutsche Bank.

Mr Rustagi and the bank declined to comment on the outcome of a disciplinary yesterday. But whatever happened, CDO traders and others familiar with the business say there must have been some kind of management and control failing.

The world of synthetic collateralised debt obligations and of so-called correlation trading is incredibly complex and fast-moving. New products, some of them high illiquid and difficult to trade, are created all the time.

It is attracting some of the brightest young bankers and maths graduates from throughout the world. But it often leaves senior managers and executives casting round for advice from independent experts about the actions of their subordinates.

Losing a senior in-house specialist can, therefore, be a blow. Deutsche Bank recently lost Mark Stainton, its experienced head of CDO trading operations. He went to Citadel Investment Group, a hedge fund. Other staff have also moved on.

The German bank would not comment about the case, but a person familiar with it said the fact that Mr Rustagi's position had not gone on for long without being noticed meant the management controls were working.

However, Mr Rustagi is thought to have built up the position over at least two months. One person at a rival bank says: "Something like this points in one direction only: management failing."

A trader at another rival says a weakness seemed likely in the overall control of Mr Rustagi's trading position because he was operating quite freely in an area that was relatively new and illiquid. "Anshul was a young guy, but bright and very ambitious and he had been successful," the trader says. "We hear he was given a lot of latitude by management."

Mr Rustagi, 26, is a graduate of the Indian Institute of Management, a leading business school. But he was a relatively junior trader and, according to a former Deutsche Bank employee familiar with the CDO desk, he would have been monitored.

"Typically there is an independent controlling function that audits traders' positions," the person says. "Obviously they are checking on a regular basis how traders value their products. The frequency of checks depends on the underlying liquidity of the product involved."

Mr Rustagi was mainly involved in trading CDOs based on the iTraxx index of credit default swaps - derivatives that act as a form of insurance against corporate borrowers defaulting on their bonds. Such trades are relatively liquid and their values can be quite easily assessed.

However, one person familiar with the case says the alleged discrepancy in Mr Rustagi's trading position was not in the more liquid iTraxx product but in non-standard index trades.

With the more illiquid, bespoke synthetic CDOs and non-standard index trades there is no known market price for individual tranches. This means many assumptions have to be fed into the complex models used to generate the valuations for the tranches and the hedges traders apply to them.

An independent expert in the field says that usually there are standard procedures and models to follow and that traders often discuss their assumptions with colleagues and the bank's quantitative analysts to decide a fair price for a specific tranche. But the expert says: "Quants are not relied upon to model specific transactions and risk managers won't necessarily understand or be able to properly assess them, so the trader is often the glue that holds everything together for individual tranches."

At the same time, in the rapid-fire world of CDOs, traders and those who structure deals often have to move quickly to take advantage of opportunities in the market and must therefore be allowed a certain amount of leeway.

"It is almost impossible to really regulate if you get a rogue trader in some of these very complex trades," the expert says. "If you over-regulate your trading desk, you might not get any business done. By the time the trader gets approval, the trade is gone."

Another executive says managers are sometimes under huge pressure from their staff not to be too restrictive. If they feel barred from doing potentially lucrative deals they can threaten to leave.

Janet Tavakoli, an independent consultant, is convinced that the hedging model used for bespoke synthetic CDOs leads to an extreme moral hazard for traders. This is because traders have some freedom in their assumptions of how much of a hedge needs to be put in place to offset the risk of a single synthetic CDO tranche, which can change. The larger the hedge, the more credit default swaps they can sell, which boosts their income - and so their bonus - without a visible change in the risk profile of their position.

"As a trader, by manipulating my hedge ratios, I can create a large net long position in credit risk that is virtually invisible," Ms Tavakoli says. "There's a lot of this to come and it's just waiting to be discovered. If this is what happened at Deutsche, then good on them for discovering it, but this is just the tip of the iceberg."