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This $2bn mess has uncanny historical echoes

By Gillian Tett

In May, I wrote a column that warned that the fast-growing world of exchange traded funds was heading for a scandal. To be honest, my expected timeline was years, not months.

But history is playing out faster than I guessed. We do not yet know precisely what has gone wrong at UBS; and, in particular, with the conduct of Kweku Adoboli, the ETF trader. But when regulators eventually unpick this $2bn mess, I would hazard that one culprit will turn out to be a pernicious cocktail of opacity, complexity and naive enthusiasm for innovation.

For what has happened in the ETF world in recent years has some uncanny echoes of what took place with collateralised debt products last decade; and the fact that it was those CDOs which caused such terrible damage for UBS in 2007 just reinforces the historical echoes. And the bitter irony.

Consider the parallels. On paper, ETFs (just like CDOs) look like a wonderful idea; they are vehicles that enable investors to gain exposure easily to a diverse range of different asset classes, without having to pay the ridiculously high fees demanded by the active fund management industry – or engage in stock picking, say, on their own.

So, unsurprisingly, the sector has exploded: annual growth over the past decade has been 40 per cent on average, as banks have marketed these products to their client base as a “safe” investment. Indeed, if you look at the charts tracking ETF growth in the past three years, they look extraordinarily similar to the CDOs charts back in 2005: the lines all point to the sky.

But, as with CDOs, this growth has come at a cost. Although the first generation of ETFs were very stodgy – composed of cash equities, say – more recently banks have started creating more exotic structures to boost returns. In Europe, for example, so-called “synthetic” ETFs, or packages of derivatives, have become very hot and now account for almost half of all ETFs.

Worse still, potential conflicts of interest have emerged within the banks too: not only do banks sell ETFs to their clients, but they also manage the trading flows that occur when the portfolios are hedged and rebalanced. Or, as the Financial Stability Board observed in a brilliantly prescient report earlier this year: "the dual role of some banks as ETF provider and derivative counterparty" creates dangerously close ties.

And the industry is marred by opacity too. As far as individual investors are concerned, individual ETFs seem pretty transparent; after all, their price can be monitored on an exchange (which is why they are often presented as "safe"). But what is often opaque is the way that banks manage the funds, particularly since many banks use black boxes to determine how to hedge and rebalance these portfolios (via so-called "equilibrating" mechanisms). It is impossible for outsiders to track the vast quantity of trading flows that occur around the ETF industry, as this hedging occurs, particularly since these flows often blur the banks' own "proprietary" trading and "client" trading.

Of course, in theory, senior bank managers should be able to monitor this. But, as ever, cultural and structural problems have sometimes prompted them to look away: precisely because ETFs have been labelled as "safe" and "transparent" by the industry, they have not featured as a danger spot on risk managers' radar screens. Once again, there may be echoes of those CDOs: one reason why UBS racked up such vast losses in 2007 on CDOs, for example, was that AAA-rated CDOs were classified as safe and profitable in internal risk management reports – and nobody felt any need to probe. (Check out the 2008 UBS shareholder report for a fantastic, highly detailed account of this).

All of this, of course, may end up raising big questions about UBS's management (did anybody, I wonder, actually read that 2008 shareholder report?). It also poses challenges for the regulators. Earlier this year, partly at the prompting of the Bank of England, the Financial Stability Board started delving into the issue. The International Monetary Fund and Bank of International Settlements have written reports too. But this does not appear to have produced any rapid action so far, partly because the release of these reports prompted a veritable army of bankers to start lobbying against any clampdown.

Hopefully, though, the story of UBS should now put more fire in the regulators' belly. If so, it may have actually done the financial industry a favour; after all, as I noted above, in its basic (vanilla) form, the ETF idea is a sensible one and very useful for investors. But if the sector is to flourish again, it needs to go back to its roots, and become more simple and transparent. Rather, in fact, like the credit markets after 2007. Anybody know how to translate "déjà vu" into Swiss German?

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