Board Perspectives: Risk Oversight

Reducing the Risk of Rogue Trading

Issue 25

A major bank's recent public disclosure that it had incurred around US$2 billion in trading losses is a stunning example of what can happen when the trading of financial derivatives goes awry. Because this situation is neither new nor limited to the financial services industry, boards and senior executives may want to consider asking hard questions about their organization's use of financial instruments that, if not used properly or as authorized, could have explosive consequences.

Key Considerations

"Tone at the top" is vital to managing the use of financial derivatives, as dysfunctional behavior can undermine established policies and controls, creating organizational "blind spots" that can lead to inappropriate risk-taking. For example, lack of transparency, conflicts of interest, a flawed "star system" or a warrior "eat what you kill" or "shoot the messenger" culture may encourage undesirable behavior.

Effective internal control design, including segregation of authorization, execution and settlement activities, is the first line of defense against unauthorized trading or speculation. Written risk limits, automated exception reporting, pre-approved products, counterparty criteria and close supervision, among other things, are critical to ensuring that risk control policies are followed. Effective ongoing monitoring of key controls by middle- and back-office personnel and an effective escalation process for calling out rogue behavior provide the second line of defense. Periodic separate evaluations by qualified internal auditors provide the third.

Beyond the impact of culture and the effectiveness of internal controls, following are important questions for boards and senior executives to reflect on:[1]

1. **Are we using derivatives to speculate on markets? If so, who is doing it and why?** – On what are these bets being placed and how often? Trading derivatives for profit is a very different end game compared to using them to manage risk. Clarity of purpose is important if internal controls are to be effective in identifying off-strategy behavior.
2. **Do our systems tell us what we need to know regarding our current positions?** – Financial markets can change significantly in a very short time, so periodic reports on positions may have limited usefulness.
3. **Do we know the sources of our risks and how they affect our operations?** – An enterprisewide view of risk and how the activities of the enterprise, including those within individual operating units, affect risk are essential. Relevant views of risk might include a unit, product, counterparty or market view.
4. **How are we valuing our positions?** – Marking derivatives to market in accordance with a frequency driven by the complexity and significance of the company's positions is vital. If proxy values are used for illiquid derivatives whose valuation is derived from underlying assets, interest rates, exchange

[1] These questions are adapted from an op-ed by Richard C. Breeden, "Directors: Control Your Derivatives," *The Wall Street Journal,* March 7, 1994.

rates, indexes or other interests, risk to extreme market shifts increases if the positions are substantial and the complexity of the instruments confound the efforts of the board and senior management to understand them. The value of these "exotics" may be derived from mathematical models that are not tied to market price quotes on equivalent transactions. Some assumptions about yield curves, volatilities and other inputs fed into these models may be rendered invalid quickly from unexpected market shifts. Liquidity risk, or the exposure to loss resulting from the inability to convert assets to an equivalent cash value, can have significant adverse consequences depending on the nature, valuation and volume of the illiquid assets.

5. **If we are using derivatives to hedge risk, what and how are we hedging and for how long?** – No matter what the hedging objectives are (e.g., hedge interest rate risk, currency risk, volatility risk), there almost always is some basis risk. In many environments, basis risk often refers to the residual financial risk that remains after a financial hedge has been put in place. For example, in the case of interest rate swaps, the basis is the difference between two floating rate indexes. If a corporation converts floating rate debt to fixed, basis risk exists if the swap pays LIBOR while the firm's funding strategy is based on U.S. commercial paper rates.
6. **Does our compensation structure encourage unacceptable risk-taking?** – For operating units with significant risks, it helps to identify the processes most likely to drive substantial business risk. Trading activities contributing to potential market, counterparty, concentration and commodity price risks are examples of such processes. Compensating traders without adjusting for the risks their activities create, or for how long the company will be at risk before profit is actually realized, may encourage undue risk-taking. Clawbacks, deferred payments and other tools may help align payments with risk outcomes and actual firm performance.
7. **Who is overseeing the use of derivatives in our company?** – Depending on the nature and extent of derivatives activity, accountability for their appropriate use and control may rest with the CEO, the CFO, a designated unit or another arrangement. Likewise, the board of directors should assess its appropriate oversight approach (e.g., through a separate committee or special subcommittee).

Questions for Boards

Depending on the extent and nature of financial derivatives use in the organization, the board of directors may want to consider the above questions.

How Protiviti Can Help

Protiviti assists companies in the financial services, energy and other industries with evaluating their policies, procedures and control structure over the use and trading of financial instruments in the context of the organization's objectives in deploying these tools in the business. Additionally, Protiviti personnel have investigated numerous instances of trading losses and have assisted control organizations and internal audit staffs in analyzing and evaluating potential risks within trading portfolios.

About Protiviti

Protiviti (**www.protiviti.com**) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE® 1000 and Global 500 companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

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