Controls and governance in order to mitigate rogue trading

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In light of the Renaissance Capital "rogue trader" incident, which caused the company to lose $10 mln on unauthorised bets as well as the Societe Generale "rogue trader" who caused the bank to lose EUR 4.9 bln and also having in mind that these are not unique cases, financial services companies must put in place proper controls and governance in order to mitigate such rogue trading and to ensure that risk management and settlement are effective.

A thorough investigation of how rogue trading can happen must be made. By understanding how it happens it will be much easier to prevent it from happening again.

What the "rogue trader" in the case of SG did was quite simple. He was buying futures contracts and he was "hedging" his position by selling fake contracts (fictitious transactions). In this way his net exposure was within the defined limits and did not raise alarms to risk managers and compliance officers.

Controls and governance to mitigate rogue trading

Random checks

Compliance, risk managers and internal auditors must perform scheduled checks as well as random checks. By knowing the time of the checks traders could avoid fraudulent activity at those times.

Consolidate market exposure limits

Risk managers must check consolidated market exposure limits of the various products that might be under the responsibility of different departments so as to monitor the total exposure of a trader who might trade in different products which are separately monitored.

Up-to-date technology

Almost all monitoring software quickly become out of date and rogue traders can find loopholes. So it must be constantly updated.

Compensation system

The compensation scheme that is now applicable for traders (based on profit) can develop a risk-taking culture to traders and lead them to wrong behaviour. Traders motivated by their desire for higher bonus often overlook risks. This can be changed to a combination of profit and risk exposures controls.

Limits on trading lots

By limiting the trading lots that can be executed with one push of a button, like for a example a trader with a trading limit of 5 contracts he has to press the button 20 times to execute a transaction of 100 contracts, will enable the trader to realize the risks that he enters into.

Traders activity monitoring

The transactions and the activities of the traders must be monitored, in the same way as the transactions and activities of clients, in order to identify behaviours which are not in line with the said limits or are suspicious of fraud. Large transactions both in number and volume, large number of cancelled orders or amended orders must be reported.

Furthermore the following controls must be applied:

Clear separation of responsibilities and powers between the different departments so as to avoid overlaps apt to conceal evidence of malpractice or to misrepresent the truth.

Segregation of duties between Traders, Client department and the Back-office department in such a way that the settlement and confirmation of transactions is not performed by the same individual. Furthermore each department is monitored and controlled by separate individuals

In all events, there must be an appropriate segregation in respect of those responsibilities and functions whose exercise by one and the same individual might result in inadequate control, in the concealment of any errors or malpractices or in any abuse of powers or abusive practices apt to expose the applicant or its customers to unreasonable and unacceptable risks.

Introduction of Chinese walls – Physical separation and independent operation of organizational units (traders Client department, Back-office department etc)

Reputational risks

Rogue trader cases like Renaissance and SG can lead to severe reputational risks. There is a risk that the reputation of the institution will be damaged in such a way that it will be regarded less positively. Confidence of depositors, creditors and the general marketplace towards the company may also be diminished. Furthermore it might cause a loss of confidence in the integrity of the institution. Depositors might withdraw their deposits and shareholders sell their shares. All these risks can lead to severe financial damage in addition to the damage caused by the rogue trader.

Suggested measures

Institutions should take immediately measures in order to mitigate these reputational risks. Senior management should provide the required transparency to the public demonstrating their honest and sincere effort to face the problem and take all required measures to prevent it for happening again. Senior management and chairmen must accept their part of responsibility and submit their resignation to the BOD, which should decide whether to accept them or not and disclose the reasons of its decision to the public. In this way the confidence of the public/customer in the integrity of the institution will be reinforced. Full cooperation should be provided to the regulatory authorities. This will give the message that the institution has nothing to hide and that the incident will be fully investigated and all losses will be identified and reported. Furthermore this demonstrates the intention of the institution to apply all required measures and regulatory authorities' guidance in order to avoid similar evens in the future.

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