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The **Banking Brief**

Issue 01 Financial Services

Rogue trading: risks and considerations

Background

The recent court ruling against Kweku Adoboli has highlighted again the problem of rogue trading incidents and the cost to banks. The losses incurred by Adoboli are the most recent in a string of rogue trading incidents, which have caused significant financial and reputational loss and in one extreme case, the collapse of Barings Bank.

Notable rogue trading losses include the following:

- Kweku Adoboli, UBS – USD 2.3 billion
- Jérôme Kerviel, Société Générale – EUR 4.9 billion
- Brian Hunter, Amaranth Advisors – USD 6.5 billion
- Nick Leeson, Barings Bank – GBP 827 million

The recent sentence handed down to Adoboli makes this an opportune time to revisit some of the key points for banks to consider.

Key messages

- There is a risk of banks becoming complacent as time passes and there are no incidents.
- There is often the perception that each rogue trading incident is different and therefore, it is difficult to learn lessons from the past. This is not necessarily true as there are actually striking similarities between some of the cases noted above.
- While there is a low risk of occurrence, the impact is significant both in financial and reputational terms, and hence boards and senior management should continue to focus on this area.

The KPMG view

From our experience, there are a number of areas, which banks and financial institutions should consider, and if necessary address, as part of their overall response to rogue trading risk.

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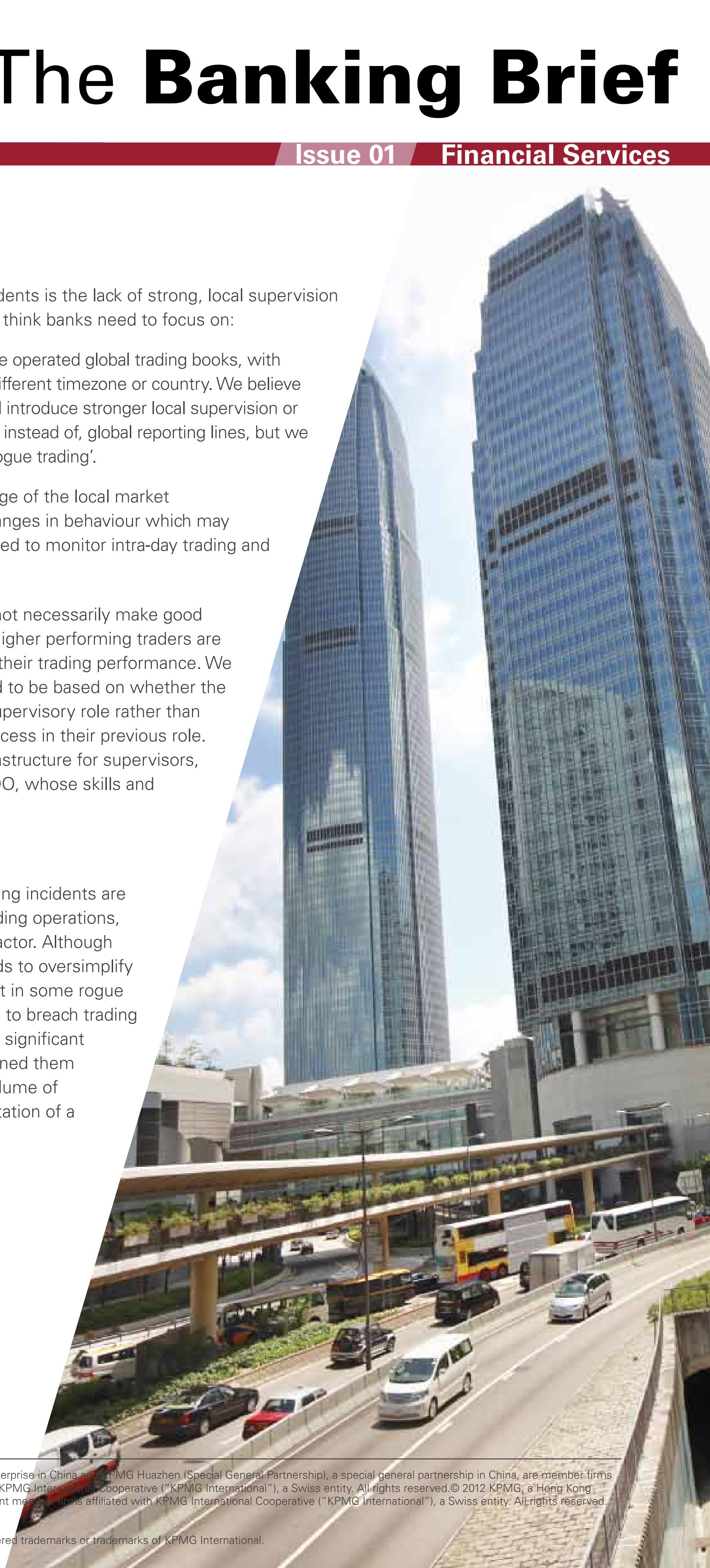

Direct supervision

A key lesson learnt from rogue trading incidents is the lack of strong, local supervision of traders. There are a number of areas we think banks need to focus on:

Location: For a number of years, banks have operated global trading books, with traders often reporting to a supervisor in a different timezone or country. We believe that banks need to rethink this approach and introduce stronger local supervision or reporting lines. This may be in addition to, or instead of, global reporting lines, but we feel this is an important step in mitigating 'rogue trading'.

A local supervisor will have better knowledge of the local market characteristics, is better able to identify changes in behaviour which may indicate a problem, and is much better placed to monitor intra-day trading and positions.

Quality of supervisors: Good traders do not necessarily make good supervisors. However, in many banks the higher performing traders are promoted to supervisory roles because of their trading performance. We think such personnel decisions ideally need to be based on whether the individual has the qualities required for a supervisory role rather than their revenue generating capabilities or success in their previous role. Alternatively, there should be stronger infrastructure for supervisors, including a strong business manager or COO, whose skills and expertise will complement the trader.

Culture

There is a widely held view that rogue trading incidents are caused by aggressive, male dominated trading operations, making organisation culture an important factor. Although elements of this notion may be true, it tends to oversimplify a complex situation. It is true, however, that in some rogue trading incidents, the culprits were allowed to breach trading mandates or control standards without any significant repercussions, and this may have emboldened them to continue and increase the extent and volume of their rogue trading. This is a direct manifestation of a substandard organisational culture.

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This may not necessarily mean there is a poor culture throughout a bank, but often shows divergence between senior management's view of what the culture should be and the actual culture on the floor of the trading room. Implementing a culture is difficult, but we believe the right incentives can help align the culture in the trading room with managemen's aspirations. We consider the following to be some of the key points, which management should consider and focus on:

- Set bright-line rules for all traders regarding what is expected, what will not be tolerated in terms of complying with control and governance standards, and what the consequences will be.
- Link performance-related pay in part to compliance with control and governance standards, rather than making it wholly revenue-based.
- Prohibit any exceptions if a control or governance bright-line rule is breached, regardless of the revenue generated by a trader.

We also see issues that need to be addressed in the culture of banks' middle office, back office and risk functions. Staff in middle and back offices need to be encouraged to employ their intellectual curiosity and follow through on any trades or explanations, which do not feel right or are inconsistent with other information. This requires front office management to ensure that any queries raised by the back office are given appropriate attention and addressed properly. It may also require middle and back office management to focus less on efficiency or process targets and more on properly resolving queries.

Front to back role

As banks have tried to become more cost efficient, this has resulted in more specialisation and the development of silos, with Product Control, Market Risk, Operations and Finance all becoming more focused on their own areas. Although this can drive cost savings, there is often nobody with an end-to-end view of the process. One feature of rogue trading incidents was that the concealment mechanisms would cause a break or query in one area, which was then quickly rectified and then arose somewhere else. There was no-one to 'connect the dots'.

We see real value in banks employing someone who has a front to back view of the controls at a desk, asset or room level, and who can start to identify patterns of control breaks and 'connect the dots'. This requires an appropriately senior and experienced person as well as enhanced management information to allow them to see all issues arising across the trade life cycle.

Enhanced management information

As noted above, we believe that introducing a role with a front to back view of all controls at a desk, asset or room level will, to a certain extent, help mitigate the risk from rogue trading. However, this role can only be truly effective if the quality of management information is good and easily allows key trends to be highlighted. The fragmented nature of trading systems at many banks can make this complicated.

We are aware that many institutions are looking to enhance the level of management information on trading activities to provide key metrics and to allow better monitoring of Compliance, Product Control, Operations, Risk and Finance. For many banks, this remains a work in progress.

There are a number of key detective controls or risk indicators which can be monitored together to help identify suspicious activities or patterns of trading for a particular trader, which would then need to be followed up on. These include:

- **Cancelled and amended trades:** This has been a common concealment mechanism used in past rogue trading incidents. Banks should focus on understanding the rationale for high numbers of cancellations and amendments; reporting the MTM impact of cancellations and amendments, where possible; observe trend analysis; and ensure that front office supervisors review and query these appropriately.
- **Net vs gross positions:** Rogue traders in the past have had low reported net positions, which consisted of large offsetting gross positions (genuine and fraudulent). Banks should focus on monitoring the level of gross positions and further investigating those where the size is not commensurate with the P&L or trading mandate.

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- **Funding position:** Rogue traders may have to fund large losses they have run up on external positions (either exchange traded or collateralised). However, most institutions only look at funding at a house level, and therefore large funding positions at a desk or trader level cannot be identified. We believe banks should work towards attributing funding at as low a level as possible, which will allow easier identification of external positions which are inconsistent with trading mandates or the profit from a desk.
- **Confirmations and extended settlement:** Another concealment mechanism, which has been used is entering forward settled trades, which are not usually confirmed in the market. Confirmation procedures have generally been tightened, particularly for trades with extended settlements, but a periodic review is necessary to ensure any changes in product or market convention have been addressed appropriately. We also believe banks should try to report the MTM impact of unconfirmed trades or disputed trades.
- **P&L attribution:** This is a key control, but often suffers if not all elements of P&L are explained. The control can be improved and enhanced by not only explaining all elements of P&L (including new trade P&L) but also by linking it to other information. This would include the size of the net and gross balance sheet positions, the risk position and a general understanding of the market dynamics appropriately.

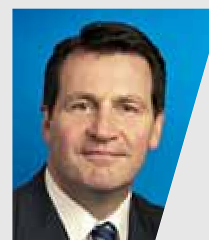
Contact Us

Paul McSheaffrey
Partner
Financial Services
Tel: +852 2978 8236
paul.mcsheaffrey@kpmg.com

Rita Wong
Partner
Financial Services
Tel: +852 2978 8172
rita.wong@kpmg.com

Martin Wardle
Partner
Financial Services
Tel: +852 2826 7132
martin.wardle@kpmg.com

Simon Topping
Head, FS Regulatory Centre of Excellence
Asia Pacific
Tel: +852 2826 7283
simon.topping@kpmg.com



Gary Mellody
Partner
Financial Risk Management
Tel: +852 2685 7659
gary.mellody@kpmg.com

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