

SURVEY: TROUBLE IN TRADING

French bank fraud fiasco has lessons for energy traders



Barbara Shirley
Managing Director
UHY Advisors-Texas
www.uhy-us.com

Houston is the epicenter of global energy trading, and home to banks that trade billions of dollars in fossil fuel futures daily.

For companies not in the financial services industry, events such as the recent French bank fraud are blunted by distance, time, language or even hubris. Nonetheless, there are a plethora of risks for energy sector companies, particularly those with commodities trading functions.

The energy trading business is inherently risky and can be a hotbed of fraud and damaging behavior.

In early July, Société Générale Bank was fined \$6.3 million for lacking internal controls which allowed a 31-year-old trader to create \$7 billion in losses. According to a report by French banking regulators, "The fraud was facilitated, or its detection delayed, by supervisory weaknesses over the trader and the market activities checking."

But these fines and losses pale in comparison to the scandal's true scope — the aggregated value of Jerome Kerviel's unauthorized trading is estimated to be \$73 billion — greater than the bank's entire market cap.

If a 31-year-old trader in France can circumvent Société Générale's supposedly airtight system, what risks loom for energy futures trading?

• **Process: Your theory vs. their reality.** To reduce the risk of illegal or hidden trading, a company's first step should be a review of the compliance to current policies and procedures to ensure employees, particularly those with access

to sensitive information, are following the firm's operating procedures.

Société Générale had procedures in place, but a rogue trader with a working knowledge of the system created work-arounds. It is prudent to conduct an independent review of current systems, including penetration testing to uncover weaknesses in a trading company's risk and fraud systems.

Risk management is a continuous process, not a one-time event. It should be undertaken from a global, and not a silo/department view. In the case of the French bank, trades were obfuscated through entries in multiple general ledgers; early reports indicate there was no aggregate command and control in place, opening the door for fraud.

Trading company management needs to have a macro view of all activity and be able to detect whether losses or gains in one trading group, for example, could be hidden by the activities of another.

• **People: The wild card.** Most commodities traders are a certain breed. An article in Prudentrader.com cites three trader personality types: intuitive, data crunchers and impulsive. Impulsives, as expected, are those who present the greatest risks, because they thrive on the inherent risk of their vocation, and often don't let the facts alter their judgment.

Those individuals can be a blessing, because they are smart enough to make calculated risks which pay larger rewards. But the associated curse can be the inherent risks requiring controls. Such individuals are best managed through the right tone at the top.

Management, directors and audit committees of energy trading companies must be introspective about the tone they're setting for traders in particular and employees in general. While the lure of a lucrative yet questionable deal may be appealing today, one has to weigh that against fostering an environment

that ferments fraud, risk and other bad behavior that can cost future money, time and reputation.

• **Technology: Past performance and future activity.** The same technology that empowers traders to leverage small changes in market value into large profits can be used to regulate fraud and non-compliant actions. Sophisticated tools like data mining can examine trading patterns and detect anomalies as an electronic "early warning" system against fraud.

The energy trading business is inherently risky and can be a hotbed of fraud and damaging behavior.

The adoption of enterprise resource planning tools in manufacturing industries now provides the technology backbone for governance risk and compliance modules which can essentially repurpose the same data sources that manage effective production, and deploy it to ensure companywide risk management and compliance with internal procedures and regulatory requirements.

Companies such as SAP and DoubleCheck provide such software, which are now migrating into nonmanufacturing industries. Whether a trading company uses a full suite of governance risk and compliance tools or just elements of a well-designed data mining program, technology is one of the best tools for predicting fraud risk.

The very fact the technology is in place can dampen the desire to commit risky or fraudulent behavior. ■