

# Over exposed?\*

## Managing the risk of fraud in commodity trading

Whilst recent high profile cases of fraud in trading environments have made the headlines, in reality most instances of fraudulent trading activity go unreported and all too often undetected by management before it is too late. In addition, although all commodity trading firms will have considered the risk of fraud and put in place controls to mitigate this risk, these measures may not be as robust as previously thought. This leaflet explains how PricewaterhouseCoopers can help commodity trading businesses better understand the risks of fraud and offer solutions to identify gaps in controls and make the changes necessary to reduce those risks.



**Analysis of incidents of recent high profile frauds reveals a number of themes:**

- Frauds were generally committed by front office individuals (as opposed to multiple persons) with knowledge and access to the middle and back office systems and/or processes.
- Red flags were dismissed, ignored or undetected (e.g. lack of mandatory vacation policy/lack of enforcement, working excessively outside trading hours and operational and risk management irregularities).
- Frauds occurred over a long period of time in companies where large positions are carried in the course of normal business.
- Structural issues existed such as lack of segregation of duties and proper oversight.

## How much is fraud costing your business?

Whilst misappropriation of assets is a significant and prevalent concern across all industries, for commodity trading companies a key area of concern is the making of fraudulent positions and the realised losses that can stem from these once they unwind.

The consequences of fraud are clear both in terms of financial impact and in terms of damage to reputation.

Have you considered...?:

- How much you are losing in aggregate to fraud?
- How much potential litigation would cost?
- Legal and regulatory aspects: new Fraud Act, anti-money laundering regulations, FSA fines for not taking appropriate preventative action.

The size of the operation does not limit the impact of the fraud – as small organisations can be faced with very significant losses given the potentially large principal sums involved.

## Warning signs?

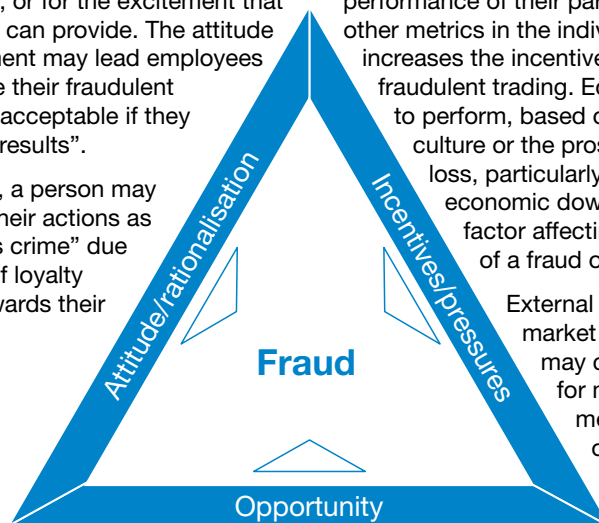
There are three common factors often present when a fraud occurs: incentives/pressure to commit fraud; attitude/rationalisation; and opportunity. Fraud can occur when one of these elements exists, but the risk intensifies if they are all present.

Traders may commit fraud for the sake of their image, their pride in the organisation, or for the excitement that risky trading can provide. The attitude of management may lead employees to rationalise their fraudulent activities as acceptable if they are “getting results”.

Alternatively, a person may simply see their actions as “a victimless crime” due to the lack of loyalty they feel towards their employer.

The extent to which a trader’s remuneration is linked to the performance of their particular desk or other metrics in the individual’s control, increases the incentive to undertake fraudulent trading. Equally a pressure to perform, based on company culture or the prospect of job loss, particularly during an economic downturn is a key factor affecting the likelihood of a fraud occurring.

External factors such as market expectations may create incentives for more senior members of the organisation.



A fraud can only occur where the opportunity arises. Opportunities exist in many forms and it is necessary to take a step back and consider the organisation as a whole in order to identify potential risk areas.

In energy trading terms, ‘rogue trading’ is a significant concern, but this may indicate a deeper collusion, such as between front and back office to alter the timing of trades or create fictitious receivables.

**55%**  
of UK businesses surveyed always carry out background checks on staff and potential staff.

The nature of many profit driven commodity trading organisations requires an atmosphere where there is a pressure to perform and where high performances are rewarded. Whilst reducing those pressures would reduce the risk of fraud, such action could be counter-intuitive and hence such incentives and pressures represent inherent fraud risks. Companies can impact the attitude of staff through a focus on ethical behaviour in hiring and during the course of business and taking a strong line against those who deviate from such behaviours. However, the most significant means by which companies can reduce the overall fraud risk is through reducing the opportunities to commit fraud.

# 43%

of companies surveyed reported one or more significant economic crimes during 2003 to 2007.

(PwC Global Economic Crime Survey 2007)

## Fraud risk in commodity trading: where do the opportunities lie?

Front office	Middle office	Back office
<ul style="list-style-type: none"> <li>• Inappropriate access to trading, settlement and financial/risk monitoring systems</li> <li>• Lack of restriction on traders booking transactions to other books/accounts</li> <li>• Trading of new or non standard products and lack of restriction on doing so</li> <li>• Creation of unauthorised/false counterparties</li> <li>• Insufficient segregation of duties around deal initiation, confirmation, valuation and settlement</li> <li>• Lack of enforced annual leave</li> </ul>	<ul style="list-style-type: none"> <li>• Weak limit setting, approval and review</li> <li>• Weak monitoring and follow-up of large exposures and limit breaches</li> <li>• Review of daily trading activities not performed or reviewed at senior levels</li> <li>• Use of estimated, judgemental and complex valuations</li> <li>• Monitoring of net rather than gross position</li> <li>• Excessive use of spreadsheets</li> <li>• Contracts with no upfront cash-flows or margin calls</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of controls surrounding counterparty confirmations</li> <li>• Discrepancies in confirmations/settlements not monitored or followed-up</li> <li>• Lack of controls around cash receipt and payment</li> <li>• High volume of cancellations and amendments of trades</li> <li>• Failure to perform regular reconciliations</li> </ul>

## Reducing fraud risk

### – how PricewaterhouseCoopers can help

Most instances of fraud are not the result of the ineffectiveness of one control, but the breakdown of a series of controls and often a weak control environment. However these often only become apparent after the fraud has occurred and the damage has been done.

PricewaterhouseCoopers has experts in energy trading and fraud risk assessment and mitigation. We draw on skills and experience from a range of disciplines to assist clients at any stage of their review of issues around fraud, including prevention, detection, investigation and remediation of fraud, financial crime and other irregularities.

We have also developed a phased approach to help businesses move towards an optimal anti-fraud environment which can be applied to companies undertaking a detailed consideration of their fraud response for the first time, responding to new fraud concerns, or just seeking to ensure their control environment stands up to good practice.

The average loss from fraud over a two year period reported by respondents has increased nearly 40% - from \$1.7 million in 2005 to \$2.4 million in 2007.

(PwC Global Economic Crime Survey 2007)

## Getting in touch

Richard French

Director

Assurance, Energy, Utilities & Mining

E-mail: richard.french@uk.pwc.com

Tel: +44 (0) 20 7212 6427

Andrew Clark

Partner

Forensic Services

E-mail: andrew.p.clark@uk.pwc.com

Tel: +44 (0) 20 7804 5761

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2008 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

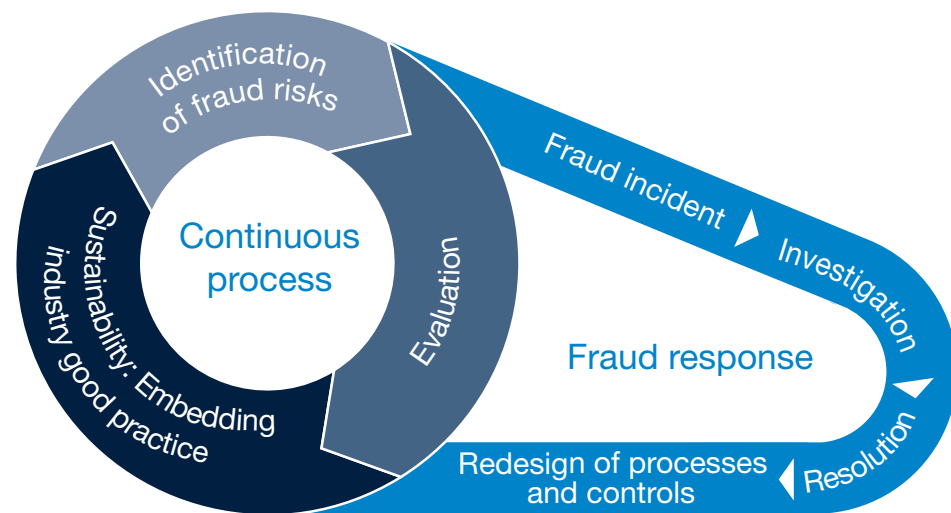
Many companies will be at different stages of the development of an optimal anti-fraud control environment. Our phased approach enables us to target solutions to meet your specific needs and considers the key aspects of the Identification of fraud risks, Evaluation and Sustainability. The identification and evaluation of fraud risks and development of controls and anti-fraud measures should be a continual process and must evolve as the company develops new products, new business processes and operates in new locations. In the event of a fraud incident, having in place a clear fraud response plan is also vital to ensure that the incident is investigated and remedial action taken.

### Identification of fraud risks

Through discussion and inquiry with management and key personnel in the front, middle and back offices we will understand the key controls in place from initiation of trade to settlement, as well as the overall control environment and anti-fraud strategy. We will create a customised risk profile based on your organisation, industry and specific risks to pinpoint the areas of your business which are at the highest risk of fraud.

### Evaluation

As part of the Evaluation phase, we use the output of the risk profile to perform a detailed evaluation of design and operational effectiveness of controls and the control environment and provide recommendations as to what action needs to be taken by management to remedy the deficiencies.



### Sustainability: Embedding industry good practice

In the Sustainability phase we can assist management to embed industry good practice controls and anti-fraud measures and develop a clear fraud response plan. We can assist in the testing and evaluation of new and modified controls and the control environment and provide on going support and training for staff to ensure that anti-fraud programmes become embedded in the business. We can also provide periodic spot checks of the effective operation of controls in place.

### Fraud response

In response to concerns about a possible fraud incident, our teams can assist by performing data analysis to identify the possible fraud, anomalous transactions or control weaknesses in the financial systems. Our teams have specific experience of working with many of the energy trading platforms in use in the UK and Europe.

Where suspicions are founded, our teams can assist internal audit or relevant departments with their investigations to ensure that evidence of the fraud is collated and retained. We can also provide support by investigating the full extent of losses and working with management to identify the causes of fraud and assist in the redesign of processes and controls to reduce the risk of reoccurrence.