PLANS OF ACTION

FINANCIAL LOSSES, DUE TO FRAUD OR ERROR, CAN HAVE A DISASTROUS EFFECT ON YOUR COMPANY. SO IT PAYS TO KEEP A LOOK OUT FOR THE WARNING SIGNS, SAYS **DANIEL MOORE** AT ERNST & YOUNG.

John Rusnak, the trader at the centre of a suspected $700m loss at Allfirst, Allied Irish Bank's US subsidiary, has brought to the fore the devastating impact a derivatives disaster can have on a company. Rusnak had worked for Allfirst for seven years. Allfirst President Susan Keating said he had been a solid performer, saying: "He was an employee of good standing."

In 1995, Singapore-based derivatives trader Nick Leeson lost £830m, which caused the collapse of Barings. When recently interviewed on the BBC, he said: "The fundamental question is, why didn't some of the middle and senior managers of the bank stop him earlier? The similarities with the Barings case seem to be very striking. The checks that should be in place to stop this sort of thing happening are extremely basic, and people haven't been doing them."

While these losses happened in a banking environment, they came to the world's attention due to their scale and scope. However, losses (due to fraud or error) are far more frequent, just on a smaller scale. These two events provide a sobering message and there are harsh lessons to be learned. This article tries to unearth those lessons by highlighting the warning signs and exploring how a more robust risk and control environment can prevent such losses. These examples show there are a number of warning signs that may point to a potential problem within a company's treasury. This does not mean that something inappropriate is happening, but they should prompt management to take a closer look at treasury operations.

KEEP MANAGEMENT IN THE PICTURE. Management must be kept informed of what the treasury is doing and why it is performing an activity. There needs to be adequate risk management information reported to both senior management and the board, including an assessment of treasury's strategy and results. I would expect to see: comparisons from month to month and year-to-date, limit reports, mark-to-market positions, funding costs, concise information around strategy and market impacts, all presented clearly, including graphs and charts. If management is not receiving adequate information, or it is not easily understood, alarm bells should be ringing. The board and senior management should assess whether the information reported is appropriate by considering whether they are seeing all they should see. Perhaps, more importantly, there should be a representative on the board who not only understands the treasury function but can explain technical aspects to other members.

PROFIT MOTIVE. Whether the treasury is a profit centre or a cost centre may make a difference to the motivation of the staff. If the primary focus is hedging, as opposed to trading, there will not be the desire to cover trading losses. However, with pressures on all parts of the business to be seen as adding value, there can be pressure even on a cost centre treasury to make money.

WRITING OPTIONS. This should be a warning sign in itself. Writing options for a treasury on face value is probably outside the sort of transaction that should be taking place. But if such transactions are to be entered into, a detailed rationale should be sought by management with a genuine exposure to the underlying asset.

REMOTE TREASURY/TRADING OPERATIONS. Having disparate treasury operations can be difficult to monitor fully. In my view, companies which allow remote and small subsidiaries to undertake trading should carefully review whether this makes economic sense, particularly when they are trading internationally highly liquid assets that can easily be traded from one point.

EXCESSIVE FUNDING REQUIREMENTS. Barings was said to be "haemorrhaging" cash in the months before it collapsed. Funding of transactions such as Rusnak's and Leeson's needed to come from somewhere. What controls are there over funding of these types of transactions in your company? Should a margin call be required, someone outside the front office, should be responsible for paying and accounting for this payment, and reporting the position to management.

OVER-RELIANCE ON KEY PERSONNEL. From a human resources point of view, a treasury should be able to call upon more than one person to fulfil one role. If someone takes leave, or is sick, then treasury should have the skills to plug the hole. If your treasury is too reliant on one key member, then you are running a risk. Have

you noticed any of these warning signs in your firm? If the answer is yes, then chances are your control environment is not up to scratch.

To follow, I will identify the general controls a treasury needs to have in place. By implementing targeted and effective controls, the risk of a corporate disaster can be reduced.

RISK AND CONTROL. There is risk (market, credit and operational risk) and possible corporate disaster. Then there are effective controls. The challenge lies, however, in the integration of effective controls into the correct area of risk – that is, how well controls are designed and executed. Every company needs to identify its areas of risk, as well as decide how much control is required. Unfortunately, there is no standard precedent for a treasury to simply follow. It is only with careful analysis and understanding of the business and its risks that controls can be implemented in a targeted and effective manner. This is where real skill and expertise is required. Correctly placed controls not only saves a company from financial loss, but also assists management in the running of the business more effectively.

So, what are the "extremely basic" controls Leeson has in mind and that every treasury should have? To follow, we'll explore the fundamental controls of treasury operations.

SEGREGATION OF DUTIES. Different treasuries are organised in different ways. No two companies are the same. However, one thing is for sure, it is vital that individuals within the front, middle (if there is one) and back offices are responsible for the different activities during the deal life cycle (such as dealing, recording, confirmation, settlement, reporting and monitoring). The front office should be responsible for developing strategy, and designing and executing transactions to manage the financial risks of the business. The back office provides the necessary checks to prevent unauthorised trading and minimise the potential for error or fraud. The role of the back office is to check, confirm, settle and reconcile trades conducted by the front office and possibly provide management information.

It is a good idea that the people who perform the respective duties of front office and back office have different reporting lines. Some companies may respond that they are not big enough or that there is not enough work to justify segregating duties. Senior management must realise the risk of such an approach, as this was reportedly the same response that internal audit received from Baring's management after a review of Leeson's activities in 1994.

GETTING APPROVAL AT EVERY LEVEL. The board has the ultimate responsibility for ensuring that an adequate system of internal controls is established and maintained. I cannot stress enough the importance of the board and senior management to understand the risks the business is facing, articulate its risk appetite and write policies and procedures that reflect that position. Every firm that has an exposure to financial risk should have a policy that covers the identification, measurement, management, monitoring and control of financial risk. Given that derivatives form an integral part of the management of financial risk, this policy should reflect the strategic, operational and tactical risks that derivatives necessarily imply.

Before engaging in any new activity, particularly derivatives, management should ensure that approvals are obtained and that adequate operational procedures and risk control systems are in place. Proposals to undertake derivatives should include:

- a description of the products, market and business strategy;
- an analysis of the risks that may arise from the activities;
- the procedures to be used to measure, monitor and control risk;
- accounting procedures; and
- tax and/or legal implications.

AN INDEPENDENT RISK MANAGEMENT FUNCTION. It is crucial that treasurer's have an independent risk management function that is involved at the appropriate levels of decision making – say, new product approval, limit setting, strategy determination. The primary components of a sound risk management process are the following:

- **Measurement.** Mark-to-market of derivatives positions is fundamental to measuring and reporting exposures accurately and on a timely basis. If this ability is not available in-house, then it should be sought regularly from counterparties, but understood by staff. Other measurement techniques, such as gap analysis and VaR, may be appropriate.
- **Limits.** The establishment of prudent limits on risk exposures is an important aspect of risk management. Boundaries should be set for risk-taking, and if these limits are exceeded, it must be brought to management's attention. Limits should play an integral part in defining trader mandates – that is type, size and term of transactions permitted and approved counterparties. Compliance with credit limits on counterparties reduces the firm's concentration of credit risk and helps diversify its risk profile. It is equally important that all limits are revisited to ensure they continue to align with management's risk appetite.
- **Reporting.** Risk reports should be easily understood by management. An accurate, informative and timely management information system is essential to the prudent operation of treasury activities.

ARE YOU UP TO SCRATCH? If you fall short on any of these points, what should you do? If you are concerned about your control procedures, then you should perform a comprehensive current state assessment of your treasury, covering both high level and detailed process controls. The risks should be identified and the key control processes analysed from a design and performance perspective. Comparing the key control processes against industry good practice will often provide a useful benchmark when determining areas of potential control weaknesses.

As a result of the review, treasury needs to develop and document the roll out of any desired future state environment. This should involve articulating a realistic vision of what you would like your treasury operations to be, and a timescale over which you wish to achieve it. Then establish compile an action plan to achieve that outcome. This may involve things such as alterations to systems and processes, reporting structures and roles and responsibilities.

From a technology point of view, some firms have used the implementation of new IT systems to develop a more straight-through treasury process (STP) to improve efficiency and to address key risks. In many cases, enhanced process automation and the re-designing of key processes can reduce and even eliminate some operational risks. However, STP still requires the same control environment as any other treasury and it would not be wise to rely solely on an IT solution to mitigate risk.

It is impossible to eliminate all losses due to error or fraud. But risks can be greatly reduced by taking some extremely basic actions.

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