

The Enemy Within

By Sue Copeman

Risks to brand, reputation and business continuity often result from externally generated events. There is a risk closer to home that can give financial services practitioners sleepless nights. History shows that losses from employee fraud - remember Barings Bank - can be devastating in terms of both financial loss and reputation.

Most financial service organisations are good at dealing with their external fraud risk. Internal fraud is another matter. The focus tends to be on looking at the 'obvious' risks - with standard controls in most of the main areas such as treasury, accounts payable, cash and assets. Unfortunately, these controls may not allow for the established senior manager who has the authority to by-pass them and is sufficiently trusted to get away with it. As far as all employees are concerned, the weakest link is probably protecting confidential and sensitive information. Some organised criminals are increasingly targeting institutions, particularly banks, to place 'moles' within the organisation and pass intelligence of customers' accounts, etc, to outside colleagues who can then use this to perpetrate frauds under assumed identities.

Hitesh Patel, head of European investigations and intelligence consultancy The Risk Advisory Group (TRAG), says that an organisation's own staff account for 80% of fraud losses. In 30% of these cases, it is senior employees, in situ for at least five years and in a position to over-ride or circumvent controls, who perpetrate the fraud. So what strategies do financial services organisations need to put in place?

Simon Dawson, head of fraud control, Control Risks Group, advocates a series of combined activities which together add up to an

holistic way of tackling fraud. Both Patel and Dawson agree that a clearly defined corporate culture, robust personnel policies, pre-screening of customers, service providers and contractors, regular assessment and a robust, efficient internal control environment are vital.

Identifying your key internal fraud risks is an important first step. Dawson considers that financial services organisations often do not appreciate the true nature or cost of the internal risk, giving the example of a bank that wrote off £200m last year to error but had no idea whether any part of that loss was fraudulent. "Once you understand the worst threats - those with the critical capacity either to happen or to cause you damage if they do happen - you can develop the policy you need to promote a culture that is anti-fraud and encourages fraud awareness."

Part of this culture is communicating your policy on fraud to all your employees. This statement should include their duties and responsibilities for preventing fraud, the organisation's code of conduct and ethics on areas such as hospitality and intellectual property ownership, the employer's right to investigate - and what will happen to employees who get caught. Both Patel and Dawson stress the importance of management leading by example.

Demonstrating a consistent and tough response to fraud is also a key deterrent, says Patel, along with implementing a whistleblowing or other confidential reporting structure for employees to pass on details of any impropriety. And, as Dawson points out, the latter also reduces the chances of them going public with a potential scandal that could damage your reputation.

Investigating

Even with a clear anti-fraud message and strong internal controls, it is impossible to completely eliminate frauds so you also need strategies

to detect them. Knowing the warning signs, for example apparent anomalies in an employee's behaviour or lifestyle, helps. Data mining exercises can also be useful. Dawson explains: "Most organisations hold a large amount of standard information electronically - supplier files, invoice files, bank account details, employee files, etc. Data mining allows you to compare these different data bases to see if there are any unusual patterns such as employees and suppliers having the same telephone numbers or bank accounts, transfers to offshore accounts, duplicated payment of invoices and 'round sum' invoices."

He also recommends avoiding confrontation until the investigation process is complete and suspicions confirmed. It is possible to obtain a considerable amount of information covertly without alerting the employee or contravening his legal rights. For example, you can take a forensic image of the data on the suspected employee's computer - provided your organisation owns this. Subject to having a communications monitoring policy in place, you can monitor telephone and e-mail communications and analyse the telephone line call log - if once again your organisation owns the equipment used. If you suspect a corruption fraud, talking to the suppliers who tendered but failed to get a contract may be enlightening. Other measures may include surveillance with covert recording equipment or using a private investigator, as well as some discreet public record research, for example into directorships held. "There are a time and place for an interview but they should be of the investigator's choosing," says Dawson.

Naturally, it is important to steer clear of contravening relevant legislation, such as the Data Protection Act, the Regulation of Investigatory Powers Act, the Telecommunications (Lawful Business Practice Regulations) (Interception of Communications) Regulations and the Human Rights Act. Key considerations are whether the investigation is

reasonable and justifiable in the circumstances, whether the proposed action is proportionate to the seriousness of the situation, and whether the investigation is likely to involve processing sensitive personal data.

The financial services sector's internal fraud risk is higher than in most other industries. The cash or assets handled are generally readily convertible and transferable and payment normally passes before the product or service is provided. Good pre-employment screening can reduce this risk, ensuring in the words of Patel, "that there are no skeletons in the cupboard". Dawson also advocates screening existing employees where a change in responsibilities may give them a greater opportunity to commit fraud or to cover their tracks. He also stresses the importance of ensuring that suppliers of temporary staff or contractors have proper screening processes too.

Surviving a downturn

The final key area of risk for financial services organisations – the effects of downturns in national and global economic conditions - may appear to be the most difficult to manage. Prevention is not an option. However, it is possible to shore up your defences to provide some protection.

Simon Harris, managing director and head of commercial banking practice, Mercer Oliver Wyman, sees credit risk as the main threat to financial institutions. Both general economic recession and a collapse in the real estate market can lead to loan defaults. While in theory global diversification may appear a solution, in practice this can be difficult. "Most banks are predominantly exposed to their local country. Diversifying into markets where they do not have any heritage means that they are often adversely competing against local institutions," says Harris

Therefore a combination of good credit risk management and strategies for avoiding or if necessary offloading concentrations of risk can be a safer route. Andrew Gray, partner, PricewaterhouseCoopers, agrees that the threat of an economic downturn is exacerbated where organisations do not have fully diversified income streams. "However, for all financial service firms, it is essential that excessive concentrations of risk (whether to individuals, sectors or geographies) are avoided. Market leaders are employing risk-sensitive pricing and increasingly advanced risk management techniques to ensure that senior management receives timely and accurate information relating to the risks inherent in these portfolios. The FSA's proposals for UK regulated firms to conduct economic scenario modelling/analysis and stress testing on a forward-looking basis, may assist firms to 'defend themselves' against such downturns."

He stresses the need for such processes to be transparent and conducted on a local, national and global basis as necessary, and also believes that portfolio analysis may be appropriate for certain firms, depending on the nature and scale of their business. "The results of these analyses may also be linked to the amount of capital each firm holds to protect itself against such downturns."

Harris also reports that some banks have moved away from the traditional culture of focusing principally on the credit loan decision and then only periodically reviewing the loan afterwards. "Some of the banks that have experienced lower loan losses are those who have devoted less human resources to the initial decision stage and used these resources instead to monitor loans more carefully and to take mitigation measures well before the borrower is on the verge of bankruptcy. Such measures may include obtaining more collateral or reducing exposure, for example by cutting unutilised lines of credit."

He also believes that another successful strategy for reducing loss is the venture capital type of approach adopted by a few institutions to some companies in their bad loan portfolios. Where they identify a company that has hit problems not through its lack of operational viability but because it has grown too fast and taken on too much debt, they have proposed a debt for equity swap, writing off part of the loan and essentially treating the company as a venture capital investment. "Some banks taking this approach have saved their shareholders quite significant amounts," he says. Moving towards a dynamic, 'venture capital' culture with debt-for-equity swaps and distressed loan sales can deliver better value, with less downside risk, than plodding through several years of litigation to repossess collateral.

Consumer credit risks tend to be more predictable. Defaults normally run at a higher level than for commercial loans, so the spike caused by a recession is likely to be lower. Although the loss may be higher, the risk can be anticipated and built into the cost of the credit. However, there is a potential long tail risk in residential mortgage loans. This is an area where UK financial institutions are vulnerable in view of the boom in property prices and increases in the proportion of the value of the property - up to 95% or even 100% - that institutions are prepared to lend. Some may consider reducing this percentage in case of a downturn, preferring to lose market share now than experience severe losses in the future.

Gray considers that the firms that will gain most (or lose least) in a recessionary environment are likely to be those that have transparent risk-based pricing, forward looking analyses and timely and accurate management information. "Integrated risk management, and the ability to assess risks across the business, may also aid firms in such an event. Those firms that fully understand their businesses, and the risks (both

expected and unexpected) inherent in them, will profit most. Some firms will continue to be more profitable, but when the up turn comes those stronger firms will profit the most." However, with organisations already struggling with the additional demands place on them by regulators (eg meeting the Basel requirements), budgets for improving risk management are limited.

Gray also stresses that risk management should be a priority for the boards of all firms, with appropriate escalation and reporting of issues, both from the risk management function and the business. "There are other practices which should also be considered, such as appropriate remuneration policies that do not encourage risk-taking behaviour out of in line with the firm's risk appetite, the use of risk-adjusted forecasts and returns, publication of transparent information to shareholders, the markets and analysts, and ensuring that risk management adds value to the business, whether through enhancing products and businesses, or by allowing the business to more fully understand the level and nature of the risks with which they are faced. Above all, it is essential that there is an appropriate risk management culture that pervades the entire business, aligned to the underlying culture of the firm." However good its risk management and discriminatory processes, tools and employees, a financial organisation cannot outrun the UK economy risk and will need to offload some areas to reduce exposure to the effects of recession. Certainly, according to Harris, there has been recent growth in credit derivatives, collateral loan obligations and mortgage bank securities.