



# Business School

## Assignment Cover Sheet

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Marketing

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**Assignment:** Business report on NAB's rogue traders and operational risk

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UNSW  
SYDNEY

Alex Huang

The University of New South Wales

Saturday 16<sup>th</sup> April, 2022

**To the board of directors of the National Australia Bank and whom this may consider:**

This report summarizes the National Australia Bank's A\$360 million loss incurred by the Currency Options business under the Markets Division of Corporate and Institutional Banking from the year 2001 to January 2004. Weaknesses in operational risk management are discussed. Recommendations for improvements are also addressed.



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Risk5001 W14A 2022

## **Rogue traders and operational risks of the National Australia Bank**

Saturday 16<sup>th</sup> April, 2022  
Alex.Huang - z5210578

# Contents

<b>1</b>	<b>Introduction</b>	<b>1</b>
<b>2</b>	<b>Event analysis</b>	<b>1</b>
2.1	What went wrong . . . . .	1
2.2	The major event led to severe losses . . . . .	1
<b>3</b>	<b>Consequences of loss</b>	<b>2</b>
3.1	NAB's Financial loss . . . . .	2
3.2	APRA's response . . . . .	3
3.3	Human resource reformation . . . . .	3
<b>4</b>	<b>Weaknesses in NAB's risk management processes</b>	<b>3</b>
4.1	Weaknesses against technology/systems risks . . . . .	3
4.2	Weaknesses against people risks . . . . .	4
4.3	Weaknesses against process risks . . . . .	4
4.4	Weaknesses against business risks . . . . .	4
4.5	Weaknesses against event risks . . . . .	4
<b>5</b>	<b>Analysis of NAB's culture</b>	<b>5</b>
<b>6</b>	<b>Recommendations for improvement</b>	<b>5</b>
<b>7</b>	<b>Conclusion</b>	<b>6</b>
<b>8</b>	<b>Appendices</b>	<b>6</b>
<b>9</b>	<b>References</b>	<b>7</b>

# 1 Introduction

Prior to the G-7 meeting in 2003, the National Australia Bank's Currency Options business under the Markets Division of Corporate and Institutional Banking decided to take speculative risks by selling a combination of currency options. In conflict with the dealers' anticipations, the further weakening of the US dollar caused NAB to suffer further deteriorating financial loss built upon four dealers' pre-existing fraudulent actions in previous years. In the following report, the cause, the consequence, the weakness of NAB's operational risk management nature and recommendations for improvements will be discussed.

## 2 Event analysis

### 2.1 What went wrong

NAB's transaction record and value system, 'Horizon system' had a 'one-hour window'[Appendix-1] which gave four dealers in the Currency Option desk opportunities to conceal the actual loss and overstate the portfolio from the beginning of 2001[Reference2]. In addition to misrepresenting portfolio value, the four dealers have been receiving bonuses and taking undesirable speculative risks until a whistle-blower noticed the abnormal option portfolio. Other than the integrity issue of the dealer, the following problems were discovered:

- The supervisor in charge was presenting incompetence in supervision skills and regulatory understandings by approving over-limit breaches.
- The risk management and controls were not implemented properly by NAB. The concealment of losses was not exposed promptly.
- The transaction record system was inefficient to conduct consistently accurate data.
- The senior management of NAB was not aware of the bank's process risk and failed to implement prompt improvements.
- The NAB's culture shaped its employees to focus on 'good news' and omit conspicuous risk signals.

### 2.2 The major event led to severe losses

From September 2003, the urge of achieving profit targets drove the traders to start wagering on strengthening US dollar on behalf of the clients and NAB's own account by holding a complex and risky portfolio constituted by a variety of currency derivatives[Reference1]. At odds with the dealers' estimation, the G7 meeting came up with a conclusion to weaken the US dollar in order to intervene in Japan and China's negotiation on loosening the yuan's peg to the dollar[Reference4].

Instead of reporting losses and processing counter treatments, the dealers proceeded to hide total losses. As a result, NAB suffered a total loss of around A\$360 million, numerous regulatory changes were forced to be implemented and the four traders in the NAB Currency Options desk were suspended[Reference2].

## 3 Consequences of loss

### 3.1 NAB's Financial loss

From the aspect of NAB, aside from the accumulated bonus paid to the four dishonest dealers. NAB's major financial losses were incurred by asset revaluation and the subsequent loss caused by the speculative currency options.

	A\$ million
Total overstatement at 31 August 2003	5.5
False reported profit for September 2003	1.8
Actual losses for September 2003	34.8
Total overstatement at 30 September 2003	<b>42.1</b>

[Reference2]

Based on the investigation, the four dealers were reported to conceal from at least the year 2001. Total overstatement was reported to be A\$42.1 million at the end of September 2003.

Key dates	Impact on portfolio valuation	
30 September 2001	portfolio value overstated by	A\$4.16 million
30 September 2002	portfolio value overstated by	A\$7.97 million
31 October 2002	misstatement eliminated	
30 November 2002	results correctly reported	
31 December 2002	results correctly reported	
January – August 2003	profits and losses misreported	
31 August 2003	portfolio value overstated by	A\$5.5 million
September – December 2003	US dollar falls	
30 September 2003	portfolio value overstated by	A\$42 million
31 December 2003	portfolio value overstated by	A\$91.7 million
12 January 2004	portfolio value overstated by	A\$185 million
19 January 2004	portfolio value overstated by	A\$360 million

[Reference2]

As a consequence of the weakening US dollar and currency options, the dealers shorted, NAB stated an increasing total loss from A\$42.1 million to A\$360 million on the 19th of January 2004.

### **3.2 APRA's response**

In reaction to the NAB's loss, APRA gave NAB instructions on changes[Reference1].

- NAB implemented all recommended risk controls as mandatory procedures in agreement with APRA.
- Total capital's internal target was raised to 10-percent of risk-weighted assets.
- NAB was no longer allowed to use an internal model to evaluate market risk capital.
- NAB's currency option trading activities were closely monitored and limited.

### **3.3 Human resource reformation**

The center of this scandal, the four traders involved were suspended by NAB announced publicly on 13th January 2004. Traders were convicted to have jail terms in the same month[Reference8]. Four senior executives including the supervisor in charge who gave approvals to numerous breaches, Gary Dillon, the head of risk management, the General Manager of Corporate and Institutional Banking and the manager of the market division were dismissed. Yet, higher-level senior managers and the board of directors were not affected[Reference5].

## **4 Weaknesses in NAB's risk management processes**

The lack of supervision and inappreciable internal system have aggravated potential upcoming operational people risk and high vulnerability to both market and external business risk. Shortcomings of NAB's culture and lack of employees' integrity have been explored.

### **4.1 Weaknesses against technology/systems risks**

The 'one-hour-window' of the horizon system cultivated potential for abuse. Thorough technological testing and documentation on the new system before implementation were absent. Continuous monitoring and upgrading of the implemented system were also absent. Moreover, the system's weak data security and feasibility for employees to share passwords initiated the intention of internal collaboration to cheat[Reference2]. Accordingly, dealers contrived to take benefit of the system and NAB suffered consequential losses.

In addition to the innate weakness of the horizon system and its incapability to generate consistently valid data of currency options transactions, NAB's internal market risk capital model was proven to have faulty model issues. Model inaccuracy, data integrity and delayed presentation of loss have worsened the weak risk monitoring framework that NAB had.

## **4.2 Weaknesses against people risks**

Besides the dishonesty of the four traders and potentially their supervisor as well, withal the top management team's low incentive to develop NAB's risk control framework. NAB's risk management department's incompetence was proven. The existence of a total overstatement of A\$42.1 million by the end of September 2003 was unaware over 2 years. The enormous amount of limit breaches approved by the senior executive Mr.Dillon was unnoticed [Reference2]. The risk management team was ignoring obvious risk signals and failed to take proactive actions against risk.

Moreover, the corporation's validity of hiring guidelines monitoring was questionable. The supervisor of the Currency Options desk Mr.Dillon was hired in August 1998 to be one of the three members of the currency options team. Within a month, Mr.Dillon hired one of the four rogue traders, Luke.Duffy to be his chief trader[Reference6]. Mr.Duffy was later described as the 'untouchable' inside the organisation because of his connection with Mr.Dillon[Reference8].

## **4.3 Weaknesses against process risks**

The long-existing weakness against transaction risk indicated the incapability of the Horizon system neither helped NAB resist systems/technology risk, nor process risk. The innate inefficiency to record accurate transaction values. Qualified automated data verifications were absent. Furthermore, the breach actions that the senior executive was able to initiate indicated that NAB was unable to comply with both internal and external risk management framework.

Nonetheless, one of the four traders stated that he had no contact with any management above his supervisor. NAB's proper documentation and internal communications were suggested to be improved by APRA[Reference1].

## **4.4 Weaknesses against business risks**

The annual G-7 meeting is known for its influence on the global economy[Reference7]. The feasibility of taking excessively risky positions before such events by its employees was not limited. Professional economic researchers working on global influential events could provide the currency options desk risk hedging advisories were absent. The national's dealers were having insufficient understanding of consequential losses resulting from business risk.

## **4.5 Weaknesses against event risks**

The national's supervision of existing businesses needed to be improved. The internal fraud could be prevented and hence mitigate the financial loss.



## 5 Analysis of NAB's culture

NAB's corporate culture was identified to be crucial to the final loss.

- NAB's remuneration system[Appendix2]has simulated employees' incentives to cheat. NAB paid bonuses for performance over the year to the 30th of September each year. Withal the loose performance verifications, the four traders and their supervisor who received a bonus of A\$500,000 in 2003 were able to fraud[Reference6].
- NAB's senior executives were reported to have incentives to conceal risks but focus on 'Good news' when communicating with the board[Reference1]. For instance, APRA's risk revealing letter was not presented to the board in 2002 and 2003. As an outcome, the board of directors were incapable of indicating valid strategies against NAB's operational risk.

## 6 Recommendations for improvement

The followings are recommendations regarding the problems that were discussed above [in section-2.1] correspondingly.

- The senior executives should be closely monitored and conduct up-to-date studies on risk management on a frequent basis.
- APRA's recommendations on risk management should not be ignored. Trial implementations of innovative risk management would be beneficial for the corporation.
- Investment in improving existing technologies/systems associated with workflows should be increased. Collaborations with renowned third-party technology vendors could be considered.
- Senior management and the board should raise junior employees' incentives to report existing and potential operational risks directly.
- The remuneration structure and performance verification structure should be improved. Rewards for employees who make progress in mitigating operational risks should be made.

Additionally:

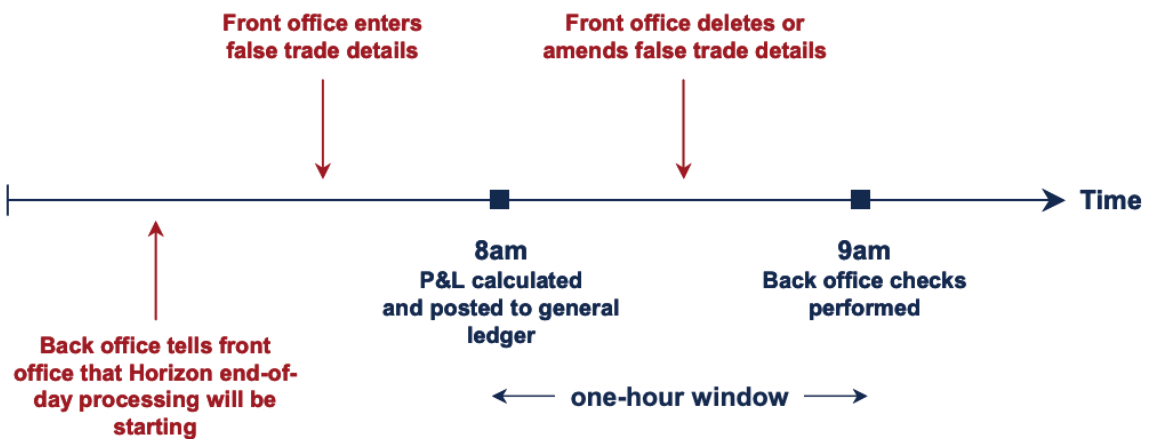
- The human resource department should be instructed to make thorough background checks on referrals. Post recruitment monitoring should be conducted[section4.2].
- Professional economic researchers working on global influential events as risk hedging advisories would be beneficial for teams like the currency options desk[section4.4].

## 7 Conclusion

This report analysed how improper operational risk management has resulted in NBA in a A\$360 million financial loss and other consequential damage to its business. No risk management scheme is invincible. The National Australia Bank's adaptability to constantly increasing operational risk in this rapidly growing world yet needs to be improved.

## 8 Appendices

- Appendix 1



[Reference2]

- Appendix 2

**Table 2.8: Bonuses paid to the Traders**

Dealer	2003 A\$
Luke Duffy	265,000
Dave Bullen	215,000
Gianni Gray	190,000
Vincent Ficarra	120,000
Total	790,000

[Reference2]

## 9 References

For reference four to eight, hyperlinks have been attached. Please use a browser to open this file and click on the sentences to access original articles.

1. Australian Prudential Regulation Authority. (2004-3) “Report into currency options trading at the National Australia Bank”.
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5. Long, S. (2004-3) “Eight sacked over NAB currency trading scandal”.
6. The Age. (2004-1) “NAB paid \$200,000 bonuses to traders”.
7. Fratzscher, M. (2008-10) “How successful is the G7 in managing exchange rates?”, pp. 5-6.
8. Johnston, E. (2005-8) “NAB dealers were the ’untouchables’”.