



## Case Study: National Australia Bank

In January of 2004, National Australia Bank announced the discovery of substantial trading losses in its foreign exchange trading operations, totaling nearly US\$400 million.

The losses occurred when traders on the foreign exchange option trading desk made bets with proprietary trades that the US Dollar would appreciate following a meeting of the G-7 finance ministers in September of 2003. Their expectations were not met, and the positions they took began to lose substantial amounts of money. In fact, the options positions which they had taken were such that their bet became larger as the market moved against them, resulting in an acceleration of losses.

In October of 2003, the traders began to mask their trading losses using a variety of methods. The traders would enter fictitious transactions that masked directional risk and those that took advantage of a system failure to properly account for the volatility smile in the options market, thus creating false trading gains. Further, the traders took advantage of an operational window which allowed for the entry of these trades just prior to the “end of day” snapshot on which risk measures were run, and the trade reconciliation process, which took place approximately two hours later. This window allowed the fictitious trades to be entered into the system prior to “end of day” and removed prior to trade reconciliation, meaning that they were able, for a while, to avoid detection.

PricewaterhouseCoopers (2004) reports that taped conversations between the traders involved show that the purpose of the scheme to hide losses was to protect bonuses that were earned on trading profits through the end of the fiscal

year in September of 2003, but which had not yet been paid to the traders as of October 2003.

PricewaterhouseCoopers (2004) concludes that the failure at NAB resulted from three critical weaknesses: the integrity of the people, the risk and control framework and the governance and culture of the organization. It seems that the traders on the desks had been hiding losses for several years. Further, even when reports were issued to management raising concerns about the foreign exchange options trading desk, management simply dismissed them as part of the process of building a currency options trading business.

The culture of the organization was such that responsibilities were “passed on”, so when risk management reported problems to middle management, they did not feel the obligation to see that issues were subsequently raised to the most senior management personnel. Absent the receipt of any concerns, the Board was unaware of potential problems that the culture kept well hidden.

The Board was ultimately determined to be responsible for the culture.

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