treasury practice FRAUD

BREAKDOWNS IN INTERNAL CONTROLS CAN COST TREASURERS DEARLY. HUGE LOSSES SUFFERED BY AIB'S SUBSIDIARY ALLFIRST FINANCIAL AND NATIONAL AUSTRALIA BANK AS A RESULT OF UNAUTHORISED DEALING DEMONSTRATE WHY. **MARTIN O'DONOVAN** REPORTS.

TRADERS BEHAVING BADLY

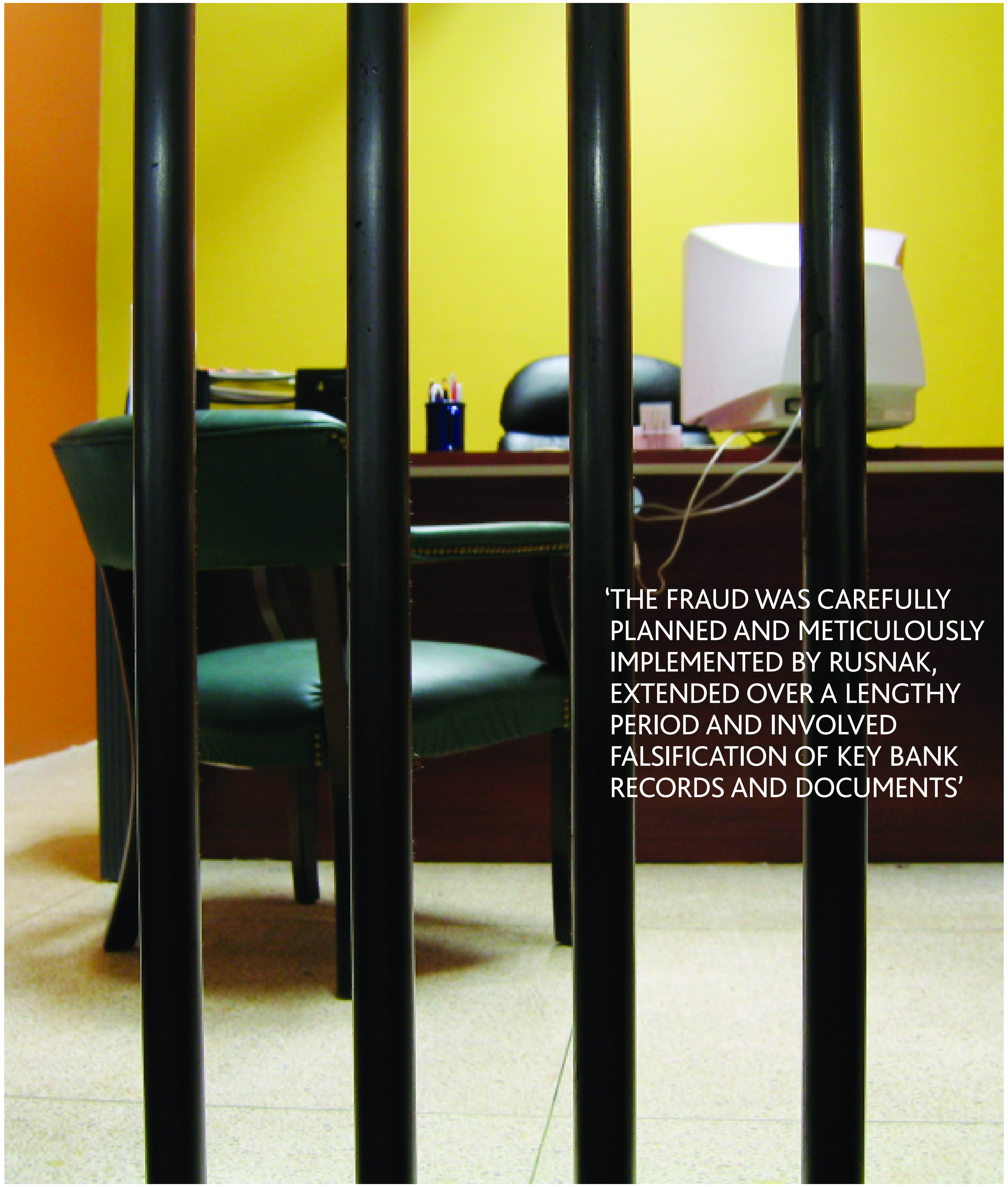
Basic back-office checks and controls may not sound exciting, but if things are not working at this level there may be trouble ahead. Grand talk of corporate governance, the Combined Code, Sarbanes-Oxley and the audit of internal controls can distract from the more mundane and routine daily tasks. But a couple of the big ticket frauds that hit the headlines in recent years demonstrate the potentially enormous costs in not getting these simple things right.

In 2002, a loss of US$691m was revealed at Allfirst Financial, a US subsidiary of Allied Irish Bank. It arose from unauthorised FX trading in Yen by their dealer John Rusnak, and a catalogue of control deficiencies that allowed this to continue for several years before it was detected.

A report into the affair published later stated: "The fraud was carefully planned and meticulously implemented by Rusnak, extended over a lengthy period of time, and involved falsification of key bank records and documents. Rusnak circumvented the controls that were intended to prevent any such fraud by manipulating the weak control environment in Allfirst's treasury; notably, he found ways of circumventing changes in control procedures throughout the period of his fraud."

THE TRANSACTIONS. Rusnak convinced his management that he was an arbitrage-style trader who could make money by running a large option book hedged in the cash market. In fact, much of his trading was really 'linear, directional trading' – bets that the market would move in a particular direction.

He was not dealing to enrich himself, quite simply he made a major mistake by investing heavily in Japanese Yen forwards. The Yen weakened and these genuine transactions became serious loss-makers. Having got himself into this position, he concocted a



'THE FRAUD WAS CAREFULLY PLANNED AND METICULOUSLY IMPLEMENTED BY RUSNAK, EXTENDED OVER A LENGTHY PERIOD AND INVOLVED FALSIFICATION OF KEY BANK RECORDS AND DOCUMENTS'

scheme to hide his losses and the size of his positions by using bogus options. These gave the appearance that his positions were hedged, and seriously distorted the bank's Value-at-Risk (VaR) computer models.

THE COVER-UP. To cover up the losses and the long position in Japanese Yen, Rusnak found a way to get fictitious put options on Yen into the books, which gave him the right to sell the Yen he had contracted to buy.

He logged a simultaneous sale and purchase of two fictitious deep-in-the-money put options to sell Yen. This meant that the up-front cash payments and receipts for these options appeared to net out.

Rusnak then left the option to buy to expire – on the day it was purportedly written. The option to sell did not expire for about a month, and 'supposedly' hedged his contract to buy Yen.

Surprisingly, these transactions failed to raise any suspicions despite the fact that the two options had different maturities but were bought for exactly the same premium. A knowledgeable observer in the back office would also have realised that the counterparty would not have allowed the option they bought to expire unexercised.

To start with, Rusnak created false confirmations for these option trades but later persuaded the back office that no confirmations were required since the two deals did not involve cash movement. Reports were not produced for deals expiring on same day as dealing. With no cash payment required he had managed to create false assets on the books which he then kept rolling forward.

SETTLING THE REAL LOSSES. Rusnak's liability from the genuine forward sale of Yen now appeared to be hedged – albeit with a 'bogus' option asset. However, as time passed he needed cash to settle the real losses on the original and genuine Yen FX forwards.

To generate cash for this, he started selling genuine deep-in-the money options. He received a large premium up-front for these, and it was almost certain that these would be exercised and require a payout in a year's time. He was open about these transactions, which were effectively loans, but managed a further deceit by removing the liability for them from the balance sheet.

FOOLING VaR. One of the control methods used by the back office to monitor dealing positions was VaR. The bogus options had the effect of reducing the apparent VaR, but in addition to this Rusnak got involved in the spreadsheets used to perform the calculations. He also entered additional 'holdover' transactions – trades done late in each day to adjust the reported numbers. A simple check to see if holdover transactions were captured in the next day's trading activity would have caught this scheme.

For some time, end-of-day exchange rates, used for revaluation purposes, were downloaded from Reuters into a spreadsheet held on Rusnak's PC and passed on from there to the back office, enabling manipulation – a further failing of the system.

In 1999 an internal audit failed to perform checks on the confirmations for any of Rusnak's deals, and in 2001 the audit checked just one of his option deals out of the 63 outstanding – half of which were false.

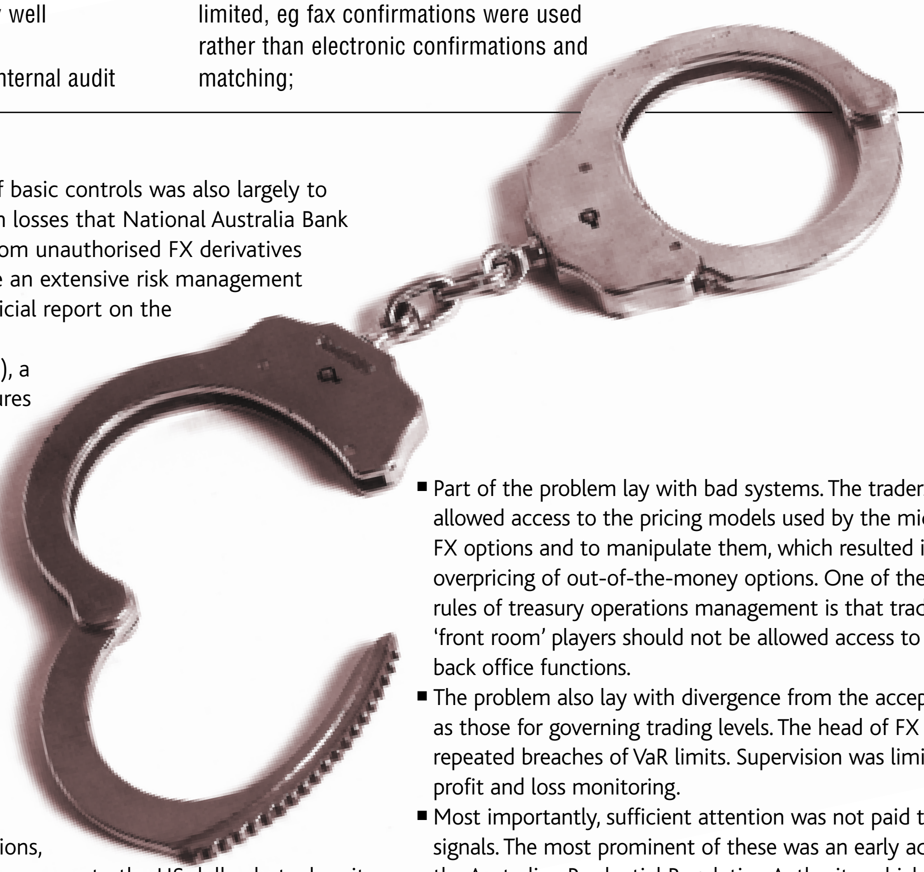
The fraud was eventually detected when a back office supervisor noticed two option trades that had not been matched with external confirmations.

Rusnak eventually pleaded guilty and was sentenced to seven and a half years in prison and given a US$1m fine.

John Rusnak: How did he remain undetected for so long?

The investigation into the Allfirst incident could not attribute the losses to a single control weakness. However, it was noted that:

- the back office failed to attempt to confirm the bogus options with counterparties;
- the middle and back offices failed to obtain foreign exchange rates from an independent source;
- treasury operational staff lacked experience and expertise;
- duties were not sufficiently well segregated;
- there were deficiencies in internal audit procedures, as well as in the treasury risk control and credit risk review areas;
- Allfirst internal audits suffered from inadequate staffing, lack of experience, and too little focus on foreign exchange trading as a risk area;
- superiors failed to supervise Rusnak's activity;
- Rusnak's telephone calls were not tapped;
- no-one spotted the sheer size of the positions despite a query raised by one of the counterparties;
- the systems used in the back office were limited, eg fax confirmations were used rather than electronic confirmations and matching;
- people in the back office did not have the required skills;
- there was a lack of clear reporting lines;
- the management in Dublin failed to focus sufficiently on the nature of the proprietary trading being undertaken;
- Rusnak's remuneration structure encouraged greater risk taking;
- Rusnak did not take his two weeks' holiday as required by US law, and often dealt from home or at night; and
- Rusnak was clever, devious and used his strong personality.



FRAUD AT NAB. The failure of basic controls was also largely to blame for the A$360 million in losses that National Australia Bank (NAB) suffered in late 2003 from unauthorised FX derivatives dealing. This happened despite an extensive risk management hierarchy. According to the official report on the case, produced by PricewaterhouseCoopers (PwC), a group of four options and futures traders in the Melbourne and London dealing rooms had been concealing losses for some time – two or more years – by incorrectly reporting genuine transactions, entering false transactions, and using incorrect revaluation rates.

The bank itself was completely oblivious to their transactions – even paying them A$790,000 in bonuses in September 2003.

By investing in currency options, the dealers built up a massive exposure to the US dollar, but when it weakened, they decided to hide their losses. They did this by entering false transactions or rates onto the system at about 8am to distort the profits and losses for the previous day. They discovered that the operations division started the process of checking and reconciling transactions at 9am, thus leaving a one-hour window to amend any incorrect rates or to reverse any false transactions.

In October 2003, the traders realised that the back office had stopped checking internal option trades. The ability to enter undetected, one-sided internal currency option trades, provided the dealers with a further method of concealment.

This all happened despite the existence of no less than five risk management committees. Three of these were at executive level, and two at board level – a board risk committee and the audit committee. So what went wrong?

- Part of the problem lay with bad systems. The traders were evidently allowed access to the pricing models used by the middle office for FX options and to manipulate them, which resulted in the overpricing of out-of-the-money options. One of the most basic rules of treasury operations management is that traders and other 'front room' players should not be allowed access to the middle or back office functions.
- The problem also lay with divergence from the accepted rules, such as those for governing trading levels. The head of FX had signed off repeated breaches of VaR limits. Supervision was limited to headline profit and loss monitoring.
- Most importantly, sufficient attention was not paid to a series of signals. The most prominent of these was an early adverse report by the Australian Prudential Regulation Authority, which was actually passed on to the audit committee. Other missed signals included some critical internal audit committee reports, unreconciled position reports, and counterparty expressions of concern at large and unusual trading.

In its report, PwC drew attention to a pre-occupation with processes rather than substance, which suggests that too much 'formalism' can distract from understanding. Reading between the lines, there seems also to have been a 'good-news culture', which suppressed the reporting of the bad news at NAB.

Martin O'Donovan is Technical Officer at the ACT.
technical@treasurers.co.uk
www.treasurers.org