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Part 1 of 1 PROPHETS OF LOSS

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The shock and awe that greeted NAB's \$360 million foreign exchange debacle suggests the event was in some way unprecedented. But recent corporate history shows that traders will be traders much the same way as boys will be boys. The reason? What makes a great trader also makes a great rogue.

"You show them you have in you something that is really profitable, and then there will be no limits to the recognition of your ability." Kurtz, the original rogue trader, confiding to Marlow, the narrator of Joseph Conrad's classic novel *Heart of Darkness*.

On January 13 this year, Australia's largest

and most successful bank, National Australia Bank, announced it had suspended four foreign exchange options dealers for irregular trading which had cost it at most \$180 million. The story, as it unfolded, became more involved and corrosive by the day. The losses mounted, the implications deepened, until it claimed the bank's chief executive, then its chairman. Much as NAB tried to clam up, the story dominated the papers, the business shows and even the mainstream news. In short order, the fiasco also claimed the head of risk, head of wholesale banking, the bank's auditors and a raft of senior executives.

And then it spilled over to the board and one of the most vitriolic brawls in Australian corporate history. The story was gasp-inducing - even NAB executives admitted to being gobsmacked - not just one rogue trader but four, who had, it emerged, treated the system with disdain for years, eventually constructing a massive fiction built on false trades and misstated profits and all in plain view of senior management and the board.

Yet it should really have come as no surprise. In one sense at least, this was not a new story. From Andy Koval at AWA in the 1980s, to the Orange County pension fund, the copper-trading company Sumitomo Corp, the collapse of Barings Bank and the humiliations of Daiwa Bank and of Allied Irish Banks, the dangers of rogues in the market have long been plain.

With rogue traders, it is the profits that are the first warning sign, not the engulfing losses that follow. Sometimes the profits are too big. Kurtz, the ivory trader, sent in as much ivory as the rest of the traders combined. The four rogues at NAB had run one of the most profitable foreign exchange options desks in the bank's history, racking up bonuses alone of nearly \$800,000 for the 2003 year while earning the bank \$40-odd million.

David Bullen, one of four traders at the centre of what had by then become the NAB's \$360 million foreign exchange options debacle, can sound like Kurtz. "They want the profit, but to get that profit they don't want to accept the risk. It's not that they don't want to take it; they just don't want to see it. So you start out not declaring all your profits, keeping some in store. And then [you don't declare] losses - as long as it doesn't hit the P&L [profit and loss account], it's OK," he told *The AFR Magazine*.

Which is why Stephen Brown, an expert in rogue strategies from New York University's Stern School of Business, exhorts organisations to "investigate anomalous returns". That may mean big profits; it may mean smooth profits in a business where there should be losses and wins - such as foreign exchange options trading.

The lesson may be simple, but it's not learnt. And at the core of that failure is the markets', the banks', own heart of darkness: that unspoken acceptance that what makes a rogue is almost indistinguishable from what makes a great trader. Too many banks have gambled that they can pick the difference.

Far from being eradicable, rogues appear to be a vital force in the market, the *id* of trading. They are the rawest manifestation of the desire for profit and risk, which is essential for banks operating in these areas. The challenge - paradoxically - is to subjugate that rampaging *id*. Without them - and the academic research supports this, to say nothing of the rogues themselves - risks taken and returns earned would be much lower. In other words, it would cost money.

When things go wrong, organisations quickly and efficiently attempt to cut the rogue free. The distancing is immediate and complete. Institutional expressions of shock and horror follow. Of course the shock and horror is genuine, but the rogues see it differently. "It isn't traders. Traders are traders. This is what they do. When they make money, they are great. When they are losers, they are nothing. Their managers discard them," says Toshihide Iguchi, whose unauthorised trading went undetected for more than a decade before he confessed, costing the Japanese Daiwa Bank \$US1.1 billion (\$1.6 billion) and its American banking licence.

Or, as one of Australia's first 'rogue traders', Andy Koval, memorably said after being fined nearly \$5 million in 1993 for forex transactions gone wrong: "I see myself as the scapegoat of a company that was shockingly badly run. It seems to me that I was the one who was taking all the risks for the company; saved the company and ... I got shafted."

With almost uncanny timing, Stern's Brown delivered his simple message about "anomalous profits" to a chief executive luncheon hosted by accountants KPMG - the soon-to-be-ex NAB auditors - on October 9, 2003: exactly the period when the four rogue traders at NAB were doubling up their bets in a bid to win back the growing losses they had been covering up in order to meet profit targets.

Just before they were discovered - thanks only to a junior whistleblower and a freak run on the market - the NAB traders had dug themselves into a \$40 million hole, having previously both overstated and understated profits. By doubling their bets, their exposure to the US dollar had ballooned from an average of around \$US250 million to more than \$US1.5 billion in just over a month.

"An important attribute of doubling strategies is that the inevitable and devastating loss is preceded by a period of high returns with low volatility," Brown wrote in a paper co-authored with Onno Steenbeck of Erasmus University, Rotterdam, on the strategy adopted by Nick Leeson which eventually destroyed the 233-year-old Barings Bank in 1995. "Conditional on the bad event not having happened [yet], the doubler's investment performance appears to indicate significant investment skill."

Colourful as it is, though, the term 'rogue trader' - first used only a decade or so ago - is misleading. It is a rogue event - a glitch, but part of the

system. Individuals with a certain pathology interact with flawed institutions in just the wrong circumstances. That four individuals were involved at NAB testifies to that. Iguchi says that beyond a certain point, and quite early, it is impossible to act alone. "Greed creates wealth; fear prevents disasters, and ego builds success," behavioural psychologists Nigel Nicholson and Paul Willman wrote in a Financial Times article after yet another such event in 2000. "What throws them out of joint are three sets of factors coming together in combination: individual high-risk profiles, poor management, and negligent corporate culture."

The fascination, always, is with the individual: the man charged; the team sacked. The outlaws, the rogues. Even the term 'rogue trader' serves the purpose of circumscribing the event. But Iguchi lays the blame squarely on the institutions. "It is not that traders were the bad apples, but the institutions. Sumitomo, Barings, and Daiwa were the rotten apples," he says.

Paul Kent, a veteran foreign exchange trader who once worked for Elders Finance, says the culture in a trading room is built around financial management, not normal management. "It can be a mind-numbing experience: no matter how much intellect you put into your strategies or your work, when you go home at night you are like a punter - you've either had a win or a loss. And that's what you are judged on," he says. Conrad thought so too. Marlow, the narrator of Heart of Darkness condemns "the company" more than Kurtz, who succumbed to its greed.

Of course, rogue trading is wrong. A line has been crossed. Nick Leeson, John Rusnak at Allied Irish Banks, Iguchi, all did or are doing time. By the end, Bullen had gone beyond any sense of transgression; he was just interested in trading, he didn't care what happened. "I was just curious to see how it turned out." He says there was no point at which his mind flashed "Wrong".

"Every time I breached [a trading risk limit], I got permission," Bullen claims, though he admits to have had "an inkling things would go wrong [when the team started to ramp up the trading]." NAB colleagues confirm the forex team had long wanted to take more risks with the bank's money.

Kent says he knew of many instances where rules were broken, limits breached, to achieve budget, reach targets. It wasn't rogue behaviour. "It was like the Kmart checkout chick tickling the till," he says. Self-justifying as these explanations may be - and again it is not just rogues but successful traders who harbour delusions about their role and culpability - they fix upon the complicity of institutions.

Indeed, the investigations into the foreign exchange options debacle at NAB emphasised management and board culpability as much as dishonest behaviour. In the wake of the Barings collapse, the then Bank of America vice-president of trading risk, Lewis Teel, said "management will" was the common factor in rogue events. "This is the star. He is the gravy train. He makes the money. Give him everything he wants. Don't let the control jerks get him upset," he said.

The NAB event followed just this path. The 'control jerks' were indeed warned off. Emboldened, the rogues, according to a report by PricewaterhouseCoopers into the NAB debacle, abused risk managers and denigrated risk systems. Bullen says the management of the bank only wanted to know that the 10 per cent per annum profit growth targets were being met. They didn't want any more information.

To reach those targets, management would have known the \$3.5 million the traders were allowed to risk each day was not enough. To achieve the smooth profit targets, the unavoidable, implicit message is 'trade outside limits'. "Everyone had to meet those profits, they talked about risk, about working for clients, but they weren't really serious - if they were serious, they would have invested more resources in staff, in systems," Bullen says. But to meet the targets, he says it was "rather simple" to negotiate around system controls - in a manner not dissimilar to a technology-savvy teenage sidestepping the rather lame controls placed on internet use by parents.

A LAX CULTURE may be the breeding ground for rogues, but not all traders in such environments go rogue. Yet, according to experts in recruitment and behavioural psychology, that's often more good luck than good judgement. Indeed, in perhaps the definitive piece of research on rogues, former University of Oregon School of Law professor Kimberly Krawiec reinforces the argument that rogues are a subconscious and driving force in markets and trading rooms.

"A cost-benefit analysis reveals that the continued existence of rogue trading in the face of pervasive legal rules providing incentives for firms to curb such behaviour indicates that financial institution management has made a conscious decision to foster an institutional culture that encourages at least some rogue trading," she writes in her paper Accounting for Greed: Unraveling the Rogue Trader Mystery (February 2001, University of Pennsylvania Law School). "Consequently, market forces cannot be expected to eliminate rogue trading, because eliminating the conditions that give rise to rogue trading is not in the best interest of traders, managers, or, perhaps, of shareholders."

Much research has demonstrated it is human nature to cash profits out too early and let losses run, rather than vice versa. And that's the game rogues and their institutions play. "In trading you can lose money. Managers don't want to know that. If a trader loses money, he can lose his job. So if he can hide the losses, he does," Iguchi says.

Trading room denizens say the culture of the institution is crucial in managing the rampaging ids of the traders. They acknowledge the world of the trading screens is dehumanising, usually, and historically very macho. "Like a football club," says Kent. A trading room is simply a schoolroom of computer screens and high-tech telephone systems which allow the traders to monitor the market live and buy and sell products.

The pace of the market and the money involved make the pressure intense. The personalities of successful traders are such that the atmosphere in the room can be anything but civil. Little wonder that most recent cases of sexual discrimination and/or harassment at banks have been in their trading operations.

Patricia Cross - now a company director but formerly the most senior woman at National Australia Bank, running its trading, treasury and wholesale banking - said a few years back, when opening NAB's then new trading room, that her first task was to "civilise" the room. "I had to get the girlie posters off the wall and maybe tone down the language a bit," she said.

Traders, judged as they are at the basest level, tend towards bravado and youth. It's no surprise that the term 'big swinging dick', denoting a high-flyer, originated in a trading room. Nor that bonuses are nicknamed 'bonos' or 'boners'. Trading room lore has it that one is 'born a trader'. In the most famous trading room of all, the New York Stock Exchange, a visitor may be surprised to hear the broad Bronx and Queens accents, rather than those of the Ivy League. These traders can be second or third generation. Their knowledge of macro-economics is minimal and they may have learned the rough laws of buying and selling from their fruit-selling fathers.

But Sarah Kearney, managing director of SHL Australia, a firm which specialises in psychometric testing, does not agree that traders are born. Getting good traders while screening for rogues is not simple, she says. "What you might be looking for is someone who comes to decisions very, very quickly, who is not always analytical, not data rational, [who has] little self-doubt and they might also tend to be very optimistic," she says.

The flip side is a candidate who is pessimistic, analyses data minutely, is cautious and often wants extra data. Of course, this person would be

The top side is a candidate who is pessimistic, analyses data minutely, is cautious and often wants extra data. Of course, this person would be hopeless trading where decisions do have to be made on the spot. "Obviously, it is a difficult balance," says Kearney. "So in this industry people tend to be hired on their history, who they've worked with, their latest deals."

A former colleague of the NAB rogue traders agrees, saying it is not difficult, particularly in the Australian marketplace, to identify who are the best candidates. "You probably know them. Or, given how much everyone moves around, someone in your shop knows them or has dealt with them. Or you know who their clients are and you can talk to them," he says. In fact, some of the NAB traders and their supervisors did, anecdotally, have 'form' at previous institutions, and one of the criticisms levelled at NAB in the investigations was a failure to conduct proper due diligence on the team.

Yet nagging questions remain as to just why some traders flame out. The factors identified by Kearney are clearly significant. Optimism, self-belief, denial. To this day, Bullen believes he and his fellow traders could have pulled NAB out of its \$360 million hole.

It's a common story. The former colleague says he has known a "number" of traders who have gone "off the rails". Most get discovered. Others do win back the losses and the matter is ignored. "But there are more than that who try and bet their way out; get into trouble; get found out. They take bigger and bigger bets or one big bet out of desperation; bet on some data release believing the market is going to gap a certain way."

Iguchi's fraud started this way. His initial loss was minor. A loss of face, a loss of advancement opportunity, if he confessed to it. But he was able to hide it. Krawiec says: "It is important to recognise that many, if not most, of a trader's attempts to evade his employer's risk and loss limits are rational and predictable behaviour." That is, traders get potentially higher rewards - and status - for taking higher risk, while the costs of losses can be hidden. But some traders are also thrilled by the high-risk strategies and so are motivated at a deeper psychological level.

Not all traders fit the profile. In the case of Iguchi and Yasuo Hamanaka, known as 'Mr Copper' or 'Mr Five Per Cent' because he controlled 5 per cent of the world copper market - who cost Sumitomo Corp around \$700,000 a day over a decade - shame was a major motivation. It was fear of losing face in the Japanese system.

NAB's Bullen, who has become a Buddhist, is perhaps the exception that proves the rule. In his limited public statements, Bullen has bewildered many with his metaphysical analysis. Bullen told this journal: "Just what is a bank? There is a board, shareholders, buildings, systems, customers, staff - but there is no 'bank'. It is a collective delusion."

He gives the impression that he has long struggled with his motivation for being a trader in the first place. An extreme relativism may serve to assuage any anxiety about the false status of being just a moneymaker. It may also serve to obscure limits and protocols imposed - in a sense, arbitrarily - by an institution.

Bullen himself, a softly spoken, slight-framed, somewhat marionettish figure - and very likeable - dismisses such psychological interpretation of his predicament. But, then, he dismisses most conventionally materialist attempts at interpretation. The trajectory of Bullen's approach to his work can be mapped through the books that have influenced him: The Disciplined Trader by Mark Douglas, then The Way of the Warrior-Trader by Richard D. McCall, followed by The Quantum Mind: The Edge Between Physics and Psychology, by Arnold Mindell. And, eventually, the I Ching.

Krawiec emphasises ordinary human nature in the rogue psychology. All humans overestimate their abilities - depending on the study, between 65 and 80 per cent of us believe we are above-average drivers. Nine out of 10 males believe their penises are longer than average. Rogue traders, given most have previously had some record of success, believe they are better than average traders and this, according to Krawiec, is compounded by another human tendency to base expectations on previous events.

"Formerly successful traders may also suffer more readily from the mistaken belief that, because they have been so successful in the past, any downturn in their fortunes must be temporary and, if hidden from supervisors for a short time, can be made up through riskier trades," she says.

In a particularly telling passage from his autobiography, Rogue Trader (Time Warner, 1997), Nick Leeson draws all these tendencies together, revealing a profile of the rogue exactly matching that sketched out by investigators: "I was determined to win back the losses. And as the spring wore on, I traded harder and harder, risking more and more. I was well down, but increasingly sure that my doubling up and doubling up would pay off ... I redoubled my exposure.

"The risk was that the market could crumble down, but on this occasion it carried on upwards ... As the market soared in July [1993] my position translated from a A#6 million loss back into glorious profit. "I was so happy that night, I didn't think I'd ever go through that kind of tension again. I'd pulled back a large position simply by holding my nerve ... but first thing on Monday morning I found that I had to use the (secret and illegal) 88888 account again ... it became an addiction."

Isolation, too, is a common thread in the history of rogue activity. Leeson was in Singapore, his head office in London. Iguchi was in New York, his head office Tokyo. Allied Irish Banks' John Rusnak was living in Baltimore, going to church, providing for his family and Barney the labrador while costing his Dublin-based bosses hundreds of millions of dollars. Even the NAB rogues, while based in the bank's 500 Bourke Street HQ, just a few floors below chief executive Frank Cicutto, were isolated. They were supposed to be located in Sydney, alongside their fellow traders, next to the physical currency dealers, within sight of their immediate bosses.

Bullen says he was all prepared to go to Sydney and had resigned himself to living a bachelor existence Monday to Friday, returning to his wife and children in Melbourne on weekends. "It would have given me time to study Buddhism," he says simply. "But they never got around to it. I don't know what happened." According to NAB sources, the shift to Sydney was just another thing the bank had cut funds for and never got around to. Like addressing failings in the risk management systems.

Conrad too thought deeply about the impact of isolation. "How can you imagine what particular region of the first ages a man's untrammelled feet may take him into by the way of solitude - utter solitude without a policeman - by the way of silence - utter silence, where no warning voice of a kind neighbour can be heard whispering of public opinion? These little things make all the great difference. When they are gone you must fall back upon your own innate strength, upon your own capacity for faithfulness."

Finally Kurtz is cut adrift from the company. "He has done more harm than good," a venal manager opines. His "method", so prized when he delivered the ivory, had become "unsound". None in the company admits that they harboured Kurtz, championed him, left him alone, when he was delivering.

And from Conrad to recent decades of corporate history. Is there a lesson to be drawn from the NAB, Allied Irish, Daiwa, Showa Shell, Orange County? Could it be learnt? Good news and profits are always welcome. Bad news is left to wither. "Middle-management people tended to sit on ...

negative reports that might be detrimental to their future, Iguchi writes in his confession. NAB's new chief executive John Stewart noted good news ran to the top like lightning. As PwC reported in its assessment: "Issues were not escalated to the board and its committees, and bad news was suppressed."

The response of the corporate, armed with the handy excuse that rogues have indeed often committed crimes, breached protocols, acted dishonestly and flaunted regulation, has been one of public sacrifice. Asked if NAB was likely to learn from its \$360 million debacle, Bullen says bluntly "not a chance". "The whole institution would have to change. They would have to accept what they were doing; managers would have to stop playing political games."

History supports his view. Daiwa paid zero attention to the lesson of Nick Leeson. One of the most egregious blunders NAB committed was ignoring the most blatant of warnings. John Rusnak's Allied Irish Banks event prompted NAB to revisit its own systems and risk management. The board asked for a report. Investigating accountants Deloitte found the Allied Irish Banks report highlighted a significant number of matters which contributed to AIB losses, yet the NAB analysis of that report "omitted to incorporate some of these factors which were potentially relevant" to NAB.

Worse, the market was aware that something was truly awry two years ago. One rival bank even attempted to warn NAB. An internal memo from that bank attempts to explain a large position: "We don't know. It's the size of the play that is grabbing attention, it's huge and perhaps it's a dealer out of control without a clear understanding of what he is doing in their risk area! ENRON?"

A senior NAB manager and risk officer brushed aside the concern, telling the rival bank they knew what they were doing. Are banks truly incapable of learning from history? Or do they subconsciously gamble that they won't eradicate rogues; that they'll just try to get them early if something goes wrong. i?? David Bullen's Fake: My Life as a Rogue Trader (Wiley, 2004)

Toshihide Iguchi's My Billion Dollar Education (JoNa Books, 2004) will be released in July.