

Investigation into the foreign exchange losses at the National Australia Bank

Report by PricewaterhouseCoopers - March 2004

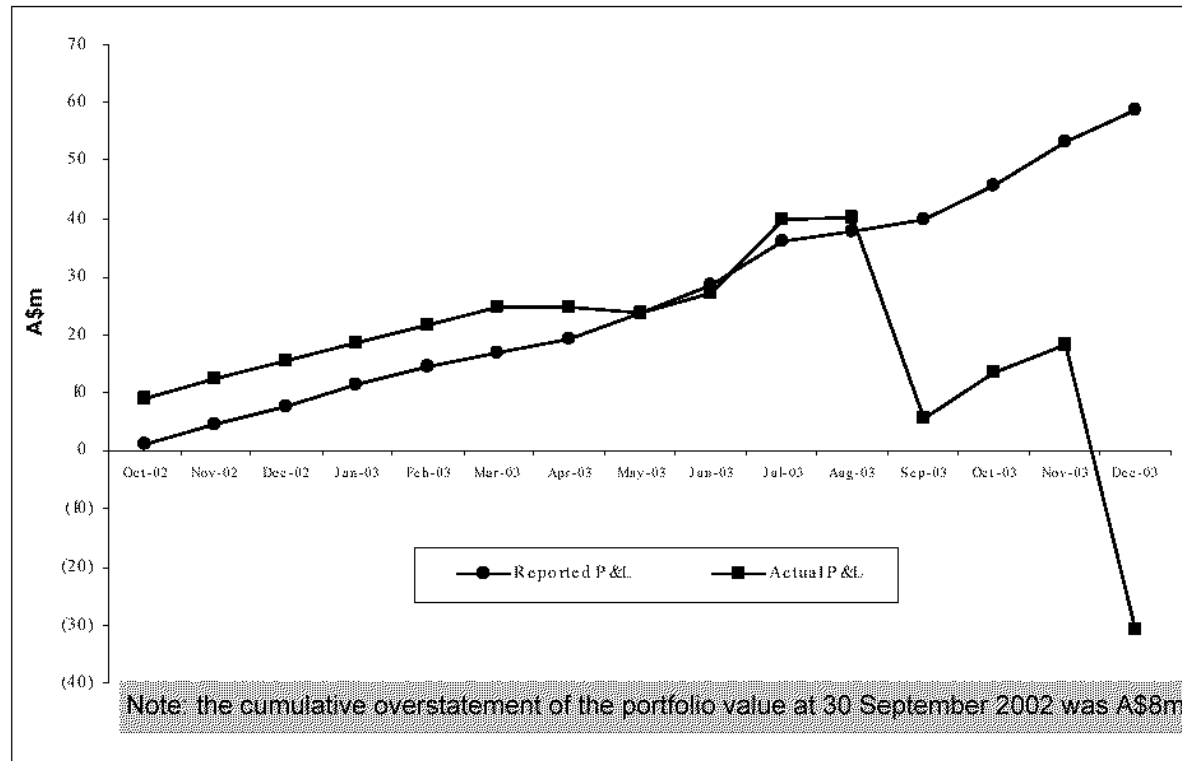
What happened

- Since 2001 four traders (the “Traders”) have been concealing actual profits using incorrectly recorded trades or false trades.
- Whilst the majority of losses have been incurred since October 2003, there were profit overstatements prior to this.
 - September 2001 \$ 4m
 - September 2002 \$ 8m
 - September 2003 \$42m

Reported profits

- Despite large losses, profits continued to be reported.

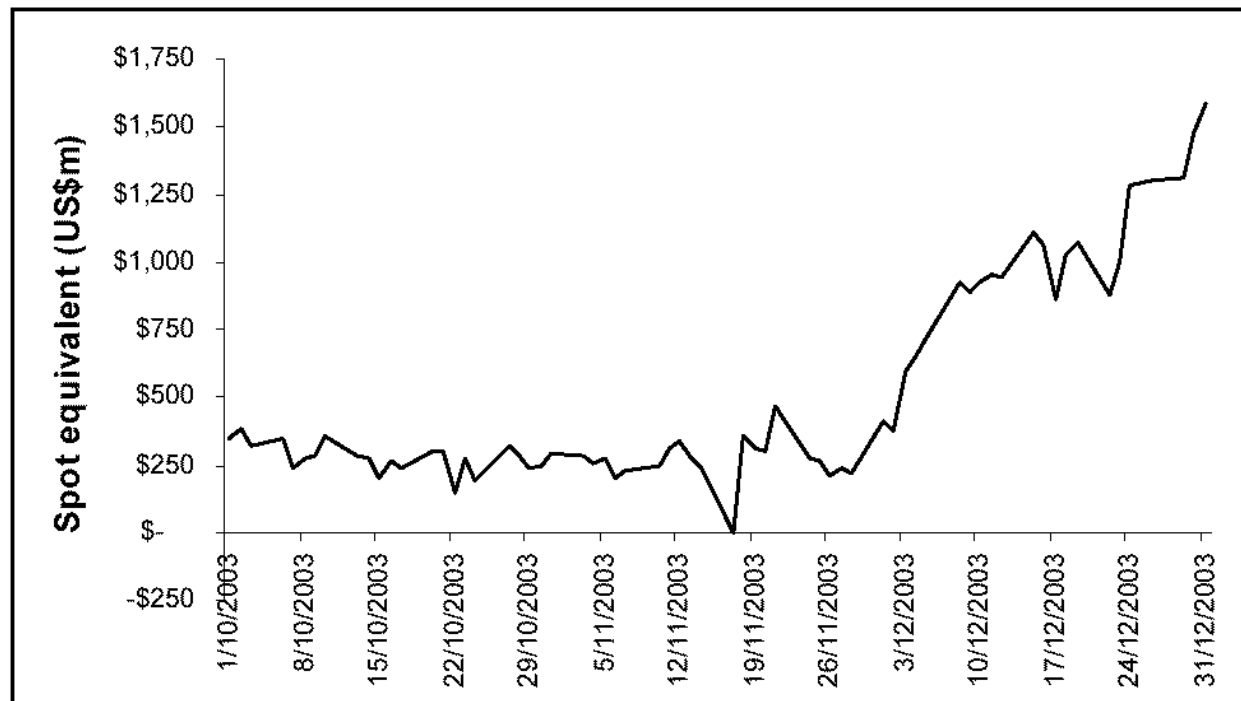
Cumulative actual and reported results of the currency options desk from 1 October 2002 to 31 December 2003



US\$ Exposure

- From 1 October 2003 to 31 December 2003 the US\$ exposure increased dramatically from US\$271m to US\$1,548m.
- The resulting loss in December was A\$49m.

US\$ equivalent exposures of the currency options desk from 1 October 2003 to 31 December 2003



Events over January 2004

- From January 1st to January 9th a further A\$85m of losses were incurred.
- On January 13th false transactions were discovered and reported to the market. These totalled A\$185m.
- The portfolio was subsequently revalued which generated further losses of \$175m.
- The total loss is A\$360m, as previously advised.

How it happened

The losses were a result of critical weaknesses across all of

1. People issues
2. Risk and control frameworks
3. Governance and culture

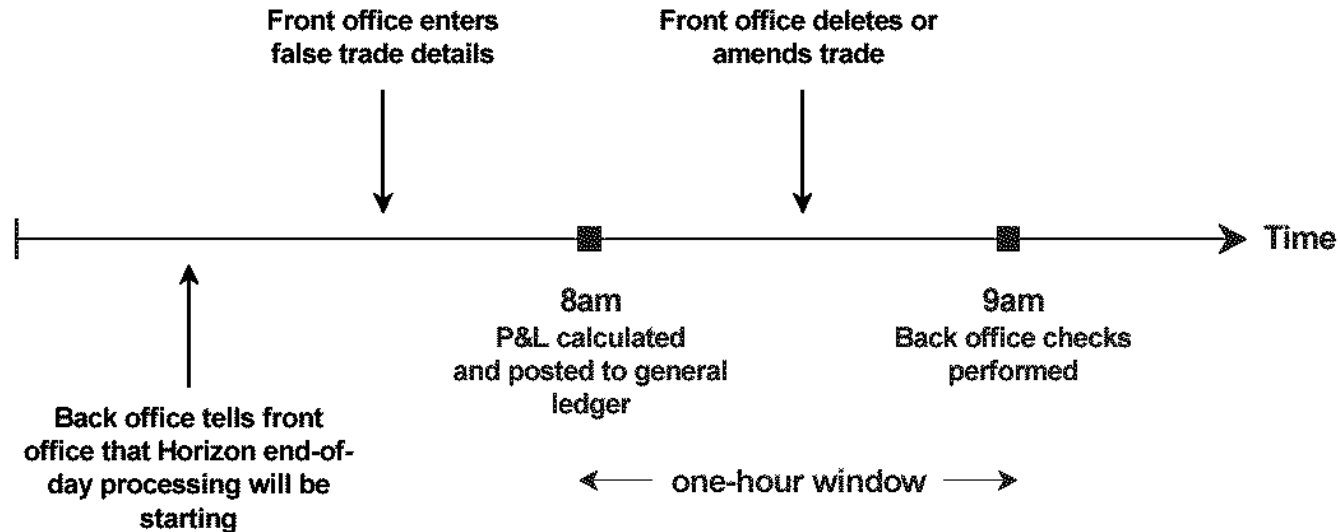
People Issues

- Traders input false data into systems to manipulate profit numbers.
- Traders had an open contempt for controls and this was not sufficiently addressed by their immediate supervisor.
- The Traders involved appear to have been motivated, at least in part, to protect their bonuses.
- In 2003 these bonuses ranged from \$120,000 to \$265,000.

People Issues (cont)

The Traders used three methods to manipulate the system

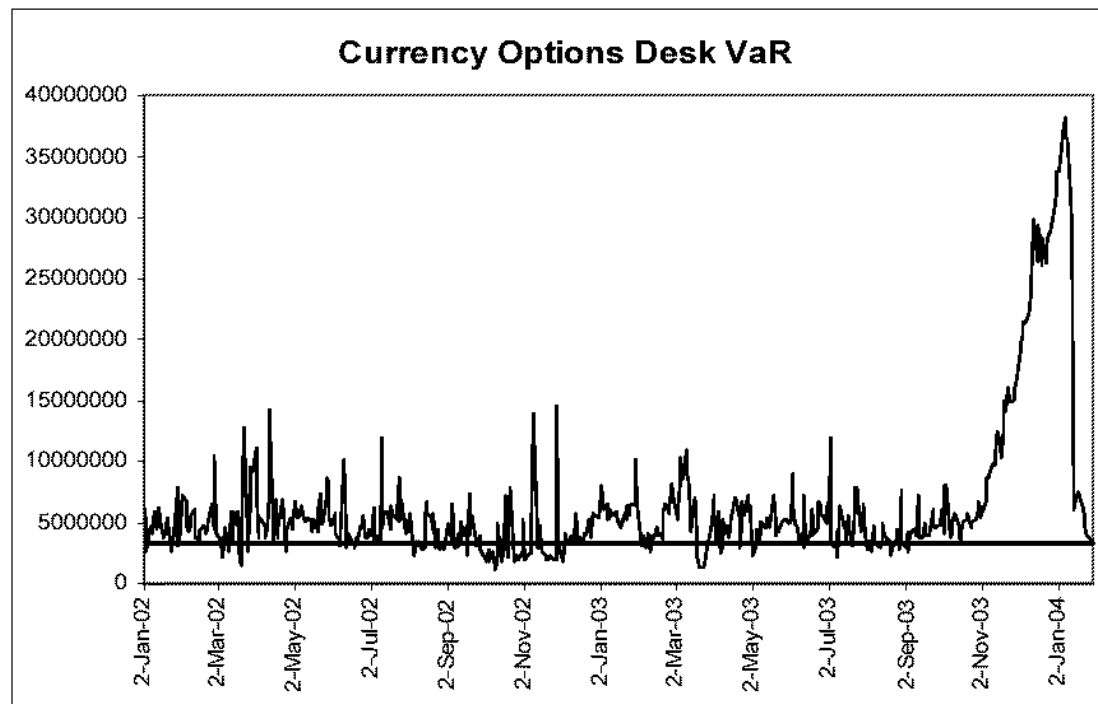
- Incorrect rates were entered into the system to move profits from one period to another taking advantage of the “one-hour window”.
- Internal (false) one-sided spot trades were entered and rolled on a daily basis taking advantage of the “one-hour window”.



- Internal one-sided option trades were created. These occurred only after mid October when the back office stopped matching off internal trades.

Risk and Control Framework

- Large and unusual activity was not investigated.
- Numerous control measures were in place, but proved ineffective.
- Measurement systems were weak and results were largely ignored.
- One such measure is Value at Risk (VaR). The VaR limit for currency option trading is \$3.25m.



Governance and Culture

- Escalation through senior management to the Board was inadequate.
- Communication to the Board was biased towards good news rather than bad news.
- Culturally there was a focus on process rather than substance.

Summary of process failures

- Currency options trading activity lacked adequate management supervision.
- Risk management failed.
- There was an absence of financial controls.
- There were significant gaps and omissions in back office procedures.

Further issues

- There was insufficient escalation to senior management and the Board.
- Warning signals were ignored or inadequately heeded.

But importantly,

- no customer of the National incurred a direct or indirect loss.

Our response

People Issues

- Staff related actions
 - Gary Dillon, Luke Duffy, David Bullen, Gianni Gray, and Vince Ficarra have been summarily dismissed.
 - Remedial actions (including position transfers) have been taken against other staff members.
- Management changes
 - Chris Lewis, Ian Scholes and Ron Erdos are leaving the bank

Our response

People Issues

- New appointments are
 - Graeme Willis to the position of Acting EGM Risk Management
 - John Hooper to the position of Acting EGM CIB
 - Shaun Dooley to the position of Acting GM Global Markets
- Cultural change program
 - To emphasise compliance and acceptance of accountability and responsibility

Our response (cont)

Risk Management

- Refine risk management framework and tighten compliance.
- Implement policy of zero tolerance to unauthorised limit breaches.
- The currency options desk is now trading within its VaR limits.

Our response (cont)

Corporate Governance

- Chairman Charles Allen and CEO Frank Cicutto have resigned.
- Principal Board Audit Committee has been re-constituted with John Thorn as chairman.
- Peter Duncan has assumed the role of chairman of the Principal Board Risk Committee.
- Ken Moss has been appointed as Senior Independent Director.

Looking Forward

- A wide range of responses have already been taken to the issues raised in the PwC report.
- We will thoroughly and methodically continue to rectify problem areas.
- Going forward we will weed out the cultural 'misfits' who are damaging the reputation of the bank.
- We are determined to restore respect for, and confidence in, the National.



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