Allied Irish Banks

Lessons learned

Some of the lessons are strikingly similar to those of other rogue trader cases, such as Barings: lack of clear reporting lines, inadequate supervision of employees and failure to control fully the business that an overseas office was engaged in. Some key risk management lessons from the case include:

- *Proprietary trading is a high-risk activity* – and it is not just a question of market risk. A relatively small outfit without access to the information, expertise and economies of scale of much larger financial institutions may find it difficult to manage and control a proprietary trading business effectively. The potential operational risks may outweigh the potential market returns, perhaps greatly.
- *Risk management architecture is crucial* – The Ludwig report concluded that risk management structure and practices within Allfirst's currency trading operations were seriously flawed. As described in an ERisk commentary earlier this year, the operational risks that this implies can quickly transform the typically large market risk exposures incurred in a proprietary trading environment into hard losses.
- *The relationship between parent company and overseas units needs to be clear* – From the Ludwig Report: "We think it is enormously important that there is unambiguous accountability." In some areas, it was not clear who was accountable to whom, and the reporting lines within Allfirst and between Allfirst and AIB were blurred.
- *Strong and enforceable back-office controls are essential* – Unlike Barings' Singapore unit, there were independent back-office staff overseeing Rusnak's activities. But the Ludwig Report says that Rusnak was able to persuade back-office staff to let normal procedures slip. Back-office staff must be empowered to stand by their guns if they have concerns about trading activity.

On February 6, 2002, Allied Irish Banks – Ireland's second-biggest bank – revealed that it was investigating an apparent currency fraud at its Baltimore-based subsidiary, Allfirst, perpetrated by a trader named John Rusnak. It soon became clear that the scale and nature of the losses would make the AIB/Allfirst story one of the biggest 'rogue trader' scandals since Nick Leeson brought down Barings bank in 1995.

The AIB board of directors quickly commissioned an independent report into what had gone wrong. Written by Eugene Ludwig, a former US Comptroller of the Currency, the report concluded that Rusnak had systematically falsified bank records and documents, and been able to circumvent the "weak control environment" at Allfirst's treasury.

Ludwig was given a limited period to carry out enquiries, and his report begins with the caveat: "We have emphasised from the outset that we believed that 30 days was inadequate to render a comprehensive report." The investigators also had no opportunity to speak with Rusnak and the report does not necessarily reflect Rusnak's understanding of events. But the report's central finding was that AIB's rogue trader had allegedly accrued losses by writing non-existent options and booking the fictitious premiums from them as revenue.

This, the report said, was in turn motivated by Rusnak's need to recoup money he had lost on a misplaced proprietary trading strategy sometime in 1997. He later compounded the situation by selling a number of real deep-in-the-money options to counterparties for high premiums, racking up huge unrecorded liabilities for the bank. Estimates of the total losses to AIB/Allfirst from the debacle now stand at around $691 million.

While the bank's solvency was not threatened in the immediate aftermath of the losses' discovery – the bank was able to absorb the losses by a one-time charge on earnings – the loss was large enough to wipe out 60 per cent of AIB's 2001 earnings and significantly deplete its capital. No senior AIB official was forced to resign over the affair, but the scandal badly dented the bank's reputation and those of some senior executives. Many commentators predict that ultimately, the debacle may result in a takeover of the weakened bank by another institution.

The case also led many observers to wonder why, seven years after the collapse of Barings, the risk management lessons of the case were apparently having to be learnt all over again – in particular, the need for robust supervision of trading activity by back-office staff and risk managers, and for parent firms to be intimately aware of what is taking place at overseas units.

Meanwhile, Rusnak – by all accounts an unexceptional individual, living quietly with his family in the suburbs of Baltimore – has joined the likes of Barings' Nick Leeson and Daiwa's Toshihide Iguchi in the pantheon of rogue traders. And bank risk managers, who had begun to think of errant traders as a phenomenon of the past, are having to face up to the fact that a new generation of rogues may still be able to evade risk controls, including such industry standards as value-at-risk.

The story

According to AIB chief executive Michael Buckley, John Rusnak was not a 'star trader' by any stretch of the imagination. Described as a 'family man' with two children and a Labrador called Barney, Rusnak was about as removed far from the archetype of the Wall Street 'master of the universe' as it is possible to get. But his trading activities appear to have much in common with more flamboyant rogue traders, such as Barings' Nick Leeson.

For one thing, the Ludwig Report says Rusnak's alleged fraud (like Nick Leeson's, and like that of Daiwa Bank's Toshihide Iguchi) appears to have begun as an attempt to cover up mistakes made some time earlier. Rusnak has refused to speak to the people carrying out the official investigation into the matter, so his true motives remain uncertain. But it does seem to be the case that he did not gain personally from his activities.

Rusnak was hired in 1993, having presented himself to the bank "as an experienced foreign exchange options trader with an arbitrage style of trading" (in the words of the Ludwig report). He told his bosses that he would carry out arbitrage between foreign exchange options and the spot and forward forex markets, a strategy that should in theory have allowed him to make money consistently by buying options when they were cheap (in other words, when implied volatility was lower than normal) and selling them when they were expensive (when implied volatility was higher than normal).

In practice, however, the Ludwig Report says that much of Rusnak's trading involved simply taking directional bets on the movement of the market, using simple currency forwards. At some point, probably in 1997, the report suggests that Rusnak made serious losses, apparently by using currency forwards to take a position on the movement of the Japanese yen. The Ludwig Report says that he then created fictitious options positions in order to hide his losses, which gave the impression that his real positions were hedged.

Another classic 'rogue' practice was the way in which Rusnak, according to the report, circumvented the supposed checks and balances on his activities. He used a number of ingenious ways of getting the fake options onto the bank's books, and his bogus options "were designed to exploit the weaknesses of the control environment around him", says AIB's official report.

Rusnak's technique was apparently to enter two bogus options trades into Allfirst's trading system simultaneously. These purported trades involved no net cost to the bank, because the first option involved receipt of a large premium and the second involved paying out an identical premium. But the first option would expire on the same day it was written, while the other option would not expire for several weeks. "Allfirst prepared no reports listing the expiring one-day options," says the Ludwig

Timeline of events

1993 John Rusnak, who had been working for Chemical Bank in New York, joins First Maryland Bancorp as a foreign exchange trader.

1999 Allfirst is formed from the merger of First Maryland Bancorp (in which AIB first took a stake in 1983) and Dauphin Deposit Corporation (which AIB acquired in 1997). Susan Keating becomes Allfirst chief executive.

June 2001 John Rusnak is promoted to managing director in charge of foreign exchange trading, in the 'global trading' division of the treasury funds management section, or front office.

Late December, 2001 Allfirst officials start to become suspicious about the sums being demanded by Rusnak to cover his trading.

January 10, 2002 Keating is appointed to the AIB chief executive committee, the group responsible for developing corporate strategy and overseeing management of AIB group.

February 4, 2002 Rusnak fails to show up for work on Monday morning.

February 6 AIB says it is investigating a suspected $750 million fraud at Allfirst's Baltimore HQ, and warns that it will take a one-off charge of

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Report, "and no-one at Allfirst paid any attention to them." The result was that fake assets were created on Allfirst's books without the bank having to pay for them, and these 'offset' certain real, losing positions in the forex markets. Had anyone been paying attention, they would have realised it made no sense for a deep in-the-money option (the option involving receipt of a large premium) to expire without being exercised by the counterparty, since this would be an extremely lucrative transaction for the option buyer – but it seems that nobody *was* watching closely.

As well as exploiting this loophole, the Ludwig report says that Rusnak took advantage of what it calls "an even bigger hole in the control environment: a failure in the back office consistently to obtain transaction confirmations". Up to September 1998, bogus broker confirmations were apparently used to validate the fictitious deals. But from then on, the report says, Rusnak apparently managed to persuade the Allfirst back office that the option pairs need not be confirmed, since they were offsetting deals with no net transfer of cash. As each bogus option expired, it was rolled over into new bogus options.

In his real trading on the spot and forward markets, Rusnak was still losing money. The official report suggests he had a profitable period in late 1999 when he clawed back some cash and reduced the bogus options positions, but then he went back to losing money on real transactions and recouping it on bogus ones.

Much of his loss-making trading was carried out under net settlement and, later, prime brokerage accounts with Bank of America (BofA) and Citibank. Under these arrangements, the spot transactions between Allfirst and its counterparties were settled with the broker and rolled into a forward transaction, then swapped each day into a forward forex trade between Allfirst and its prime broker.

These forward trades were settled in cash on a fixed date each month. The report says: "These accounts enabled Mr Rusnak to increase significantly the size and scope of his real trading. It effectively permitted Allfirst to make trades in the prime brokers' names, and it effectively made the prime brokers the back office for those trades." Rusnak's trading grew through his use of prime brokerage accounts, as did his losses – and so, inevitably, did his bogus options positions.

When Allfirst decided in 2000 that trading income should reflect a charge for the cost of balance-sheet usage, it quickly became clear that Rusnak's trading was using an inordinately large proportion of the balance sheet. In January 2001, head of treasury funds management Robert Ray noticed that Rusnak's use of the balance sheet was much greater than warranted by the size of his earnings, and ordered him to scale back his use of the balance sheet.

This left Rusnak in need of an alternative source of funds, and from February 2001 the Ludwig report says that he turned to selling year-long, deep-in-the-money options – real ones, this time, rather than bogus ones. Since these were extremely attractive to buyers, they were able to command very high

Timeline continued

E596 million ($520 million) to cover the resulting losses.

February 8 Eugene Ludwig, a former US Comptroller of the Currency, is hired to compile a report for AIB on the affair.

February 19 AIB chief executive Michael Buckley says that the origins of the scandal might stretch back to 1997, and gives the final figure for losses as $691 million.

March 12 Buckley and AIB chairman Lochlann Quinn offer their resignations to the AIB board, but neither resignation is accepted.

March 13 The Ludwig Report is published jointly by Ludwig's Promontory Financial Group and law firm Wachtell, Lipton, Rosen & Katz.

March 14 Allfirst and AIB announce that six executives who were responsible for oversight of Rusnak's activities are to be dismissed. A number of organisational and structural changes are also announced, including the appointment of an individual to oversee risk management across the AIB group.

March 17 AIB denies rumours that Allfirst CEO Keating is about to step down. Later newspaper reports claim that Keating has been given one year to get Allfirst back on track. ■

premiums (he sold five such options for a total of $300 million) but the result was that Allfirst was saddled with massive potential liabilities. Rusnak's use of the Allfirst balance sheet declined as a result of his use of these options to fund his activities, but Allfirst treasurer David Cronin was still concerned about it and ordered him to reduce his usage by the end of 2001.

The Ludwig report says that another important aspect of Rusnak's fraud was his ability to manipulate the value-at-risk (VaR) figures used to monitor his trading activities. His bogus options appeared to hedge his real positions, and so reduced his VaR. But the report says he was also able to interfere directly with the inputs into the VaR calculation used by Allfirst's risk-control group. The report says that VaR was supposed to be calculated independently, but instead relied on information taken directly from Rusnak's personal computer. This gave him the opportunity to manipulate, and ultimately to reduce, his VaR.

Allfirst's true trading position was finally uncovered when a back-office supervisor discovered that the supposedly offsetting options deals were not being properly confirmed. The supervisor directed the back-office employee involved to confirm all future similar trades.

Meanwhile, Cronin was disturbed to find that although Rusnak's use of the balance sheet had fallen to $150 million by the end of 2001 as directed, it had spiked to more than $200 million in one day in January.

From this point on, events unfolded quickly. Rusnak failed to appear for work on Monday, February 4 – after a weekend when Allfirst's back-office staff were unable to confirm his trades with his supposed counterparties in Asia. Cronin reported the problems to Allfirst's senior management. They, in turn, informed AIB in Dublin.

The aftermath

Allfirst's trading debacle eventually cost $691.2 million. AIB announced in February 2002 that it would take a one-off charge of E596 million ($520 million) against 2001 earnings to cover the losses.

AIB commissioned former US Comptroller of the Currency Eugene Ludwig to carry out an independent investigation under the auspices of his Promontory Financial Group and US law firm Wachtell, Lipton, Rosen & Katz.

> ‘Among the key shortcomings the report identified was the “flawed architecture” of Allfirst's trading operations’

Although the Ludwig Report (as it has become known) begins with a warning that it was prepared under time constraints, it nonetheless reaches some penetrating and damning conclusions about the numerous failures of risk management at Allfirst.

Among the key shortcomings the report identified was the “flawed architecture” of Allfirst's trading operations, which resulted in potential risks that outweighed potential rewards. The report noted that Rusnak was trading in essentially the same way a hedge fund might, taking directional bets on the market rather than carrying out transactions on behalf of customers. But a lone trader in Baltimore without access to the scale and expertise of a large hedge fund or a major bank did not enjoy any competitive advantage in this kind of trading. The basic nature of the forex operation at Allfirst was thus fundamentally flawed: a strategic business risk.

The report also said that:

- Senior management in Dublin and Baltimore did not pay enough attention to Allfirst's proprietary trading operation, which was not part of Allfirst's core business and was small in terms of expected profits and formal risk limits;
- Treasury management weaknesses were compounded by the fact that outside control groups were discouraged from getting access to information about Rusnak's trades; and
- AIB Group risk, AIB senior management, Allfirst senior management and the boards of both banks all simply assumed that there were sufficiently robust controls on Allfirst trading activities.

Other criticisms address the supervision of the proprietary currency trading business; the robustness of risk reporting practices; and AIB's apparent failure to heed concerns raised by regulators (including the Office of the Comptroller of the Currency) about risk management in Allfirst's trading area. It also noted that “Mr Rusnak was unusually clever and devious”, and was able to take advantage of the inexperience or poor training of back-office staff. In the wake of the Ludwig Report, AIB announced a range of organisational changes – among them, the appointment of a *de facto* chief risk officer to oversee risk management across the AIB group (AIB announced on April 19 that this role would be filled by John Heimann, an ex-US Comptroller of the Currency and banker with experience at Merrill Lynch, and the Federal Deposit Insurance Corporation). The bank said it would centralise the management and control of all treasury activities throughout the group in Dublin, and would end all proprietary treasury activities at Allfirst and at AIB's Polish division.

At the same time, AIB said it was dismissing six individuals whom it held responsible for the failure of oversight of Rusnak's activities, among them Cronin and Ray. AIB chief executive Michael Buckley and chairman Lochlann Quinn both offered their resignations, though neither was accepted by the board of directors.

The fraud was not just an embarrassment for AIB. It had some serious strategic implications for the future of the business. In particular, many banking analysts suggested after publication of the Ludwig Report that AIB might choose to sell off Allfirst to a US buyer, concentrating instead on its home business and its other overseas operations in Poland. Almost inevitably, AIB also became the target of a class-action suit filed by US investors, who alleged that the bank had published unreliable financial reports since 1999 as a result of the debacle.

‘Wider questions remain, particularly about the role of counterparties to derivative transactions’

At time of writing, US banking regulators and the Department of Justice were still investigating the case. While the Ludwig Report may be essentially the last substantial development to affect AIB itself, wider questions remain, particularly about the role of counterparties to derivative transactions.

Some commentators have suggested that a system in which large, idiosyncratic trading (reportedly questioned by some of Allfirst's counterparties and brokers) raises no red flags is in need of closer examination, though there is no evidence that individual firms at other firms knowingly assisted in any rogue trading at Allfirst. ■

This case study was contributed by Alan McNee, ERisk

Web Resources:

The Ludwig report
http://www.allfirst.com/Ludwig_report.pdf

Statements by Allfirst and AIB after publication of the Ludwig Report
http://www.allfirst.com/about_allfirst/news_2002/02_03_14m.html
http://www.aib.ie/servlet/ContentServer?pagename=AIB_PressOffice/AIB_Press_Releas/aib_po_d_press_releases&cid=1015597171590&poSection=HP&poSubSection=null&position=notfirst&rank=top&year=2001

Other Allfirst press releases
http://www.allfirst.com/about_allfirst/news_2002/2002.html

Other AIB press releases
http://www.aib.ie/servlet/ContentServer?pagename=AIB_PressOffice/PO_HomePage&poSection=HP

Financial Times Special Report on the AIB case
http://news.ft.com/ft/gx.cgi/ftc?pagename=View&c=Article&cid=FT3OIOL7DXC

ERisk Opinion column on the lessons of the AIB case
http://www.erisk.com/portal/community/viewpoint/comm_viewpoint2002-02-13.asp