The Australian Prudential Regulation Authority, HIH and the NAB (B)

After becoming head of the Australian Prudential Regulation Authority (APRA) in July 2003, John Laker was faced with a new dilemma barely a month into his tenure. APRA's August 2003 on-site visit to the National Australia Bank (NAB) revealed that the bank's risk management protocols had still not been adequately strengthened, exposing them to potentially significant problems in the future. NAB management had been slow to respond to APRA's concerns despite clear warnings in an earlier letter. In November 2003, APRA sent another letter which gave the bank until 30 March, 2004 to fix their protocols or face regulatory action. This letter was not tabled with the bank's Principal Board Audit Committee and APRA didn't get an opportunity to enforce its deadline.

On 13 January 2004, the NAB announced that it had suspended four employees over unauthorised foreign exchange trading. Apparently the illicit trades had been occurring since the previous October. Early estimates suggested losses in the region of $180 million and the matter had been referred to the Australian Federal Police for investigation. The bank also launched its own internal inquiry. NAB shares fell, wiping $700 million off the bank's market value. This scandal followed losses of $4 billion in 2001 after a failed foray into the US mortgages industry.[1] Almost immediately, APRA announced that it was looking into the matter.

This case was written by Marinella Padula, Australia and New Zealand School of Government, for Professor John Alford as a basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation. It accompanies the case 2005-13.1.

[1] Hughes, A., 'Rogue trading in the spotlight after NAB sees $180 million go down drain', *Sydney Morning Herald*, 14/1/04.

Two days later, APRA issued a statement saying that it was undertaking a review of the risk management controls employed by the National Australia Bank. Specifically, this review would examine:

- the trading activities that caused the losses, and whether the Bank's existing escalation procedures were effective;
- controls in the Bank's front and back offices; and
- weaknesses in the design and implementation of the Bank's internal control systems, including market risk management.[2]

By the end of January, the NAB revealed that the scandal had actually cost $360 million. Managing director Frank Cicutto claimed that the foreign currency traders had "exploited weaknesses in our internal procedures."[3] Earlier, David Bullen, one of the suspended traders, denied falsifying any documents to conceal his activities. In fact, he claimed that the bank was full aware of their breaches and even "signed off" on them.[4] Frank Cicutto resigned in early February, taking an estimated $14 million payout with him.

Within a month, media reports surfaced which revealed that APRA had been aware of problems at the NAB. Under questioning at a Senate committee hearing, John Laker said APRA had had concerns about NAB's activities since an on-site visit in August 2002. "I wouldn't want to embarrass NAB," he said, "but they had other episodes where they lost large amounts[5]… Let me say that we had identified concerns in the risk-management framework of NAB. We had expressed those concerns to the NAB board and management and they were responding to those concerns."[6]

On March 23, APRA submitted its review to the NAB board which released it publicly the next day. APRA's report found that:

> "The losses ultimately incurred by the National Australia Bank on currency options were caused by four currency options traders, possessed of an abundance of self-confidence, who positioned the NAB's foreign currency options portfolio in the expectation that the falls in the US dollar that occurred mid last year would reverse and volatility would stabilize. Rather than closing their positions as the market moved against them, the traders chose to conceal their true positions – allowing these positions to deteriorate unchecked over a period of three months before they were finally discovered. By that time, the positions held were totally out of control. That this was possible was, first and foremost, due to the collusive behaviour of the traders themselves. However, it can also be attributed to an operating environment characterized by lax and unquestioning oversight by line management; poor adherence to risk management systems and controls; and weakness in internal governance procedures."[7]

The traders involved had since been sacked by the bank. APRA's report also stated that "Cultural issues are at the heart of these failings… The culture that predominated at Corporate and Institutional Banking (CIB) at NAB was one in which risk management

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[2] 'APRA Review of National Australia Bank' APRA Press Release No.04.02.
[3] 'Rogue trading loss doubles to $360 million', *Courier Mail*, 28/1/04.
[4] Oldfield, S., 'NAB Scandal: Trader Hits Back', *Australian Financial Review,* 16/1/04.
[5] 'Watchdog knew of NAB risk problems', *Courier Mail,* 20/2/04.
[6] Oldfield, S., 'APRA told NAB of concerns', *Australia Financial Review*, 20/2/04.
[7] Report into Irregular Currency Options Trading at the National Australia Bank, APRA, 23/4/04, p. 5.

controls were seen as trip wires to be negotiated rather than presenting any genuine constraint on risk-taking behaviour… 'Profit is King' was an expression frequently heard in our interviews with CIB staff. As long as the business unit turned a profit, other shortcomings were overlooked."[8] As Tom Karp recalled:

> "There were still enough checks and balances that someone should have picked up somewhere. It's not as if bells weren't going off, they were; it's just that no one was taking them seriously. We put in a team of about five people who were camped at NAB for six weeks to do the investigation. The problem was the whole culture of the place: 'We're big, we're NAB, we make a lot of money out of this business and if we lose a bit here or there what's the big deal?'"

The day after the report was released by the NAB, APRA issued a statement outlining the remedial actions it required of the bank, including instituting cultural change and introducing more stringent risk-management controls. NAB's currency options desk had to remain closed until the problems were fixed.[9] To many, it was a clear sign that APRA was unafraid to exercise its powers. "Tea and Bikkies off the APRA menu" declared one article.[10] "Beefed up Body flexes its muscles" announced another.[11] But to commentators like Terry McCrann, it was a marked overreaction:

> "It sounds like big money but for a bank the size of NAB in the forex market, where trillions turn over daily, it was petty cash – even a loss of $360 million. APRA's response was all out of proportion. It forced NAB to raise $2 billion in extra capital because it lost $250 million net after tax…[APRA] supposedly raised concerns a year ago but neither insisted the right people be told, or checked the issues had been addressed. Wouldn't it have been better to bolt that door before the horse bolted?"[12]

Tom Karp, to some extent, agreed. A loss of $360 million, though a lot in absolute terms, wasn't going to "kill" the bank, which is why APRA didn't give the bank an extremely urgent deadline to fix the problem in the first place. As for being a disproportionate response, Karp commented: "The things we've required of NAB we've actually required of other banks over the past few years, so what we have done may look over the top but we can't talk about those [because of security provisions]."

An editorial in the *Australian Financial Review* agreed with the severity of the penalties meted out by APRA but also questioned the timeliness of its actions, stating: "A regulator is supposed to take the punchbowl away before the party gets out of hand. The impact of its actions are blunted if it waits until the miscreants are numb with remorse before bursting into the room and issuing fire and brimstone denunciations."[13] But Laker was unconcerned with such criticism:

> "I think it is quite clear that we'll take whatever action is required. That gets, at times, misinterpreted as a traumatised APRA overreacting… but I'm not traumatised. When there is action APRA needs to take, we'll take it – that's what the community expects us to do… I've never seen that as APRA thinking,

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[8] Ibid, p. 6.
[9] 'APRA Review of National Australia Bank' 24/3/04, APRA Press Release No. 04.09
[10] Boyd, T., 'Tea and Bikkies off the APRA menu', *Australia Financial Review,* 26/3/04.
[11] 'Beefed up Body flexes its muscles', *Australia Financial Review,* 25/3/2004.
[12] McCann, T., 'Regulations hide APRA bank failure', *The Sunday Times*, 28/3/04.
[13] 'APRA has a lot to learn', *Australian Financial Review,* 25/3/04

> ‘Oh thanks goodness, look what’s landed in our lap today. We can knock them around and really look tough.’ [Regarding NAB] I think to have done anything less than what we did would have been craven.”

In order to reassure the community that the problems at NAB were not endemic to the banking industry, APRA conducted a review into the risk management protocols at other institutions. They released their findings in June 2004 and reported no shortcomings near the magnitude of those at the NAB. As for the NAB itself, despite the fact that customers were not affected by the trading losses, the negative PR still lingered. Survey results showed that customers wanting to switch banks were less inclined to choose the NAB.[14] APRA was also still closely involved with the NAB, in contact on a near-daily basis. As the NAB had sacked all the staff connected with the scandal, they effectively wiped out an entire layer of risk management.

Overall, Laker said he was pleased with the gains being made at APRA. He observed that early warning systems and intelligence gathering were continually improving as well as their risk analysis capabilities. A dedicated insurance risk team had been created and staffing levels were up. APRA had also received a boost in industry funding to enable it to grow its staff resources and skills. Laker also found that APRA was being taken more seriously as a regulator; institutions were much more willing to comply.

Karp also found the ongoing tension between co-operation and coercion easier to manage with the creation of a separate enforcement committee as part of an APRA reorganisation in June 2004. When a frontline team came across a problem they were also responsible for the investigation, making it hard to switch gears. Now it was handed to a separate enforcement committee to pursue.

Citing an analogy, he said: “If you take a regulator like ASIC they’re like the police – if people break the rules, they fine them and disqualify them. A prudential regulator is not like a policeman, it’s more like a doctor – you’re monitoring their financial health all the time. If things start to go bad, you assist them by prescribing a remedy, but ultimately you take more dramatic action, such as hospitalisation or amputation, if necessary.”

[14] Brammal, B., ‘NAB on the nose – Bank customers turn off in droves: Nielsen’, *The Daily Telegraph*, 12/6/04.