

Australia's largest bank shaken by speculative trading losses

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Australia's largest bank and second biggest company, the National Australia Bank (NAB), has faced continued instability, including the resignation of both its chairman and chief executive officer, since it announced on January 13 that it had lost hundreds of millions of dollars in foreign currency trading. The spectacular losses reflect the increasing reliance by the NAB and other global corporations on speculation and high-risk investment activity to maintain profitability.

On March 12, the NAB sacked or forced the resignation of eight senior staff, disciplined or moved 17 others and restructured its board of directors in its latest attempt to appease investors and stem the slide in its share price. The measures followed the bank's release of a report by the accounting firm PricewaterhouseCoopers (PwC) into how the losses occurred.

The report revealed that the financial damage could have been far greater, with the potential to trigger the worst banking crisis in Australian history. The NAB's currency traders had breached trading limits on 800 occasions and, at one stage, had unhedged foreign exchange exposures of more than \$A2 billion.

This is a far cry from the situation reported in January, when the NAB initially announced losses of \$180 million, only to be forced to double that figure a week later. The bank blamed the losses on "unauthorised" trading by "rogue" employees at its foreign exchange options desk. While accepting this version of events, the PwC report pointed the finger at the NAB's poor risk management and checking mechanisms.

Both the bank and the PwC report assert that this high-risk activity was not a strategy of the bank. "It's not a systemic problem," the NAB's recently installed CEO John Stewart declared. However, information revealed in the report and from other sources over the past two months contradicts this assertion.

The NAB originally reported that an employee from outside the foreign exchange options section of the bank had detected and reported losses from unauthorised foreign exchange options trades between September 2003 and January 2004. Before any investigation, the NAB immediately stood down the four traders in the section, effectively making them scapegoats.

It soon emerged, however, that the NAB was trading at levels far higher than its official risk caps. The major Australian banks usually calculate their exchange option financial exposure by a Value at Risk (VaR) formula, which calculates the maximum probable losses that could result at any one time. The NAB's foreign exchange options cap was \$3.25 million, which meant that

the ultimate loss of \$360 million was 110 times the maximum VaR.

According to the PwC report, the irregularities dated back to 2000 at least. The report found that the foreign exchange team had increasingly upped the risks of the trades in order to recover initial losses. The team's desk bet heavily that the Australian and New Zealand dollars would fall against the US dollar, and bought and sold options accordingly. >From August 2003, both currencies rose against the US dollar—the Australian by 14 percent.

In order to hide their losses, the traders entered false transactions to the value of \$5.5 million in August. This figure accumulated to \$42 million in September, \$92 million in October and \$360 million by January.

Claims by NAB senior management that it did not know about or support the risk taking have been undermined by a number of sources.

The options team had already breached daily VaR limits hundreds of times during 2003 and these breaches were authorised each time by Garry Dillon, joint head of foreign exchange trading. The breach figures, which did not include the concealed losses, were sent to the general manager of the Markets Division and other staff. However, according to the PwC report, they were never investigated.

The traders were making large and unusual trades, which must have been obvious to senior management. The options team made \$42 million in one day, when it was budgeted to earn around \$30 million in the year. Two large commercially unviable trades with another bank in October 2003 were reported by staff to the bank's Market Risk and Prudential Control section. But it accepted the traders' explanation that the deal was to boost the section's cash resources.

Even warnings from a rival bank, the ANZ, were ignored. In March 2002, the ANZ raised concerns about the erratic deals the NAB was making. NAB representatives threatened to end dealings with the ANZ if it raised its concerns within the foreign exchange industry.

David Bullen, one of the four currency options traders told the *Australian Financial Review* that the NAB tolerated the breaches of the risk limits because the team had made important profits for the company. He said NAB had earned between \$25 million and \$45 million each year for the past three years from the currency options desk, making it the most profitable team in Australia. The NAB paid Bullen a bonus in January of \$215,000, more than

doubling his annual salary, while his colleague, Luke Duffy, received an extra \$265,000. Gary Dillon received a bonus of \$500,000.

Bullen rejected former NAB CEO Frank Cicutto's claims that the traders' behaviour did not reflect the bank's culture. "All they ever really wanted was for money to be made, and the way that came about was secondary," he said. "As long as you make money, it doesn't really matter how that money came about." The bank's annual reports suggest that the increasingly risky trading was a conscious policy. The average VaR in September 1999 stood at \$3 million, but by March 2000 it had risen to \$8 million and then \$10 million by September 2000. Over the same 12-month period, the maximum VaR rose from \$5 million to \$20 million. In an attempt to mask the risk taking, in 2000 the NAB dropped its usual practice of providing year-on-year comparisons in annual report figures.

Although it posted a \$4 billion profit last year, the NAB, like the other three major banks in Australia, has been in a desperate struggle to maintain its profit levels. Australian banks saw their gross incomes as a ratio of assets fall from 4.2 percent to 2.9 percent between 1992 and 2001, a faster decline than the world average.

The profit rates against total assets remained steady through the 1990s only because the banks cut costs by slashing thousands of jobs and closing hundreds of branches. The banks have nevertheless faced tighter margins on personal and business lending and have had to search for alternative sources of profit.

The deregulation of the banking industry in the 1980s and 1990s, which opened Australian banks to greater global competition, contributed to the decreased interest margins. The banks were pitted against larger, more profitable or more risk-inclined companies. At around 50 in the world ranking of banks by size, the NAB has a tiny proportion of the capital and market share of the larger American, European and Japanese banks.

These profit pressures were camouflaged during the 1990s stock market boom, which largely collapsed at the end of the decade. The banks then profited from the ensuing real estate bubble that sent house prices, and therefore mortgage lending levels, soaring in 2001-2003. By late 2003, however, that bubble had also begun to burst, with the Reserve Bank raising official interest rates.

In recent years, the NAB increasingly attempted to move outside its traditional Australian banking business by acquiring companies in the United States, Britain, Ireland and Asia. However, its expansion into the US home lending market by buying Homeside Lending ended disastrously. The NAB wrote down Homeside Lending's value by almost \$4 billion before eventually selling the company in 2002.

Although relatively small in relation to the NAB's overall profits, the foreign exchange losses reveal the underlying pressure to turn to speculative activity, as profits have become more difficult to generate from lending for industrial production.

On a world scale, the daily trade in foreign exchange more than doubled between 1989 and 2001, from US\$718 billion to \$1,618 billion. This was despite the introduction of the euro, which diminished the need for trades within much of Europe.

The increase in speculative trading has been reflected in several

foreign exchange scandals. In 1999, the Barings Bank collapsed after its Singapore trader, Nick Leeson, lost US\$1.3 billion in derivative trading in Asia and, in 2002, Allfirst Financial, a subsidiary of Allied Irish Bank, lost US\$690 million on foreign currency trades.

One of the reasons the NAB's share price has continued to stagnate since January 13 is that investors fear that the bank is taking similar risks in larger trading desks. Credit ratings agency Standard and Poor's responded to the PwC report by downgrading the NAB's debt rating from AA to AA-.

The affair has raised further questions about the Australian Prudential Regulation Authority (APRA), the Howard government's banking and finance industry monitoring agency. APRA is now investigating the bank's risk management policies, but it knew about the foreign currency risks at NAB for 18 months before the scandal broke. It merely politely raised its concerns with the NAB and conducted no further audits.

In a private letter to the NAB board in January 2003, APRA conveyed the results of a review of market risk in currency options conducted between 26 and 30 August 2002. It pointed to a "lax approach to limit management," "a culture of non-adherence to risk management policies" and problems with the testing and validation of the VaR model.

It is entirely in keeping with APRA's role that it sat on its hands until the losses became publicly known. It played a similar part in the scandalous collapse of HIH, one of Australia's largest insurance companies, three years ago. Its "hands-off" approach is not accidental. Treasurer Peter Costello established APRA in 1998, replacing the more interventionist supervision of the Reserve Bank, as part of the government's efforts to please the capital markets by de-regulating the entire finance industry.

The APRA investigation is likely to back the PwC report's conclusions, condemning the individual currency traders and poor risk management, without delving into the deeper causes of the losses. The bank's new CEO, John Stewart, has said he will "stabilise the ship" by reducing risk-taking. Whatever his intentions, however, objective economic pressures will push the bank, and all its rivals, toward continued high-risk gambling on global financial markets.

As the HIH disaster, and the unravelling of business empires internationally, such as Enron, WorldCom and Parmalat, have already demonstrated, the social costs of corporate collapses are borne by millions of working people, through the destruction of their jobs, savings, insurance coverage and retirement funds, as well as the crippling of basic public services. Until now, the Australian government and the financial authorities have maintained that the major banks, at least, are immune from catastrophic meltdowns. The NAB debacle reveals that such assurances may soon prove to be worthless.



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