Prime loss: A case study in operational risk

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Abstract In March 2008, Opes Prime, a small stockbroker in Melbourne, Australia, was placed into administration. This set off a chain of events that caused ANZ, one of Australia's largest banks, to become involved in a series of messy legal actions. By the end of 2008, losses at the bank had been estimated to exceed A$250m, with litigation still pending. The losses sustained by ANZ in the Opes case constitute an 'operational risk loss event' as defined under new banking regulations, Basel II. Unlike significant operational risk losses at other banks, such as those sustained by the National Australia Bank, the losses have not been attributed to so-called 'rogue traders'. However, like those well-publicised disasters, similar systemic risk management failures were apparent and sowed the seeds for the losses that were eventually precipitated by the demise of Opes Prime. In a seminal work in decision literature, Professor Barry Turner identified a number of features that are common to the development of 'organisational disasters', many of which are apparent in the events leading up to the losses at ANZ. This paper reviews the ANZ/Opes case using Turner's framework, compares it to the events at other banks, and identifies some lessons for management, risk managers and regulators.

Keywords: *operational risk, Basel II, legal risk, ANZ Bank, Opes Prime, Turner's framework*

INTRODUCTION

Using Turner's framework[1] for analysing the 'development of disasters', this paper looks at the failures of management that resulted in losses at the Australia and New Zealand Banking Group (ANZ) due to the collapse of the stockbroker Opes Prime.

An internal report into the events leading up to losses within the bank's equity finance business concluded that the problems were caused, in large part, because of risk management problems in the bank:

'In hindsight, ANZ's equity finance business should not have operated in an

> environment where *all the risks were not fully understood and managed*. The business posed unacceptable reputational and financial risks to ANZ and these were not properly identified' [emphasis added].[2]

Echoing an official report[3] into earlier losses at the National Australia Bank (NAB) by the Australian Prudential Regulatory Authority (APRA — the Australian banking regulator), the ANZ review committee's report concluded that the issues it had identified were 'in essence, *a failing of management*, both "line management" and "risk management"' [emphasis added].[2]

Employing an analysis framework developed by Turner,[1] this paper identifies some of the warning signs of the impending disaster that were ignored by ANZ's management. Similarities with other cases of operational risk disasters are highlighted and deficiencies in management controls are identified.

BACKGROUND

Securities lending, equity finance and margin lending

As defined by the International Securities Lending Association (ISLA), securities lending is:

> 'the common market practice by which securities are transferred temporarily from one party (the lender) to another (the borrower) with the borrower obliged to return them (or equivalent securities) either on demand or at the end of any agreed term'.[4]

In the present context, however, 'lending' is somewhat of a misnomer, in that legal ownership of (or title over) the securities (in this case traded equities) passes from the lender to the borrower, although the borrower must return any income, such as dividends, received from the securities while in their possession. In practice, a borrower will provide 'collateral' to the lender, usually in the form of cash, or 'near cash' instruments such as government bills, and, almost always, the market value of the securities loaned will exceed the collateral received.

The term 'equity finance' is usually taken to refer to the practice of lenders making loans to a company in return for an equity stake but is used by some banks, including ANZ, to refer to a set of services based on 'safe custody' and securities lending/borrowing within a comprehensive reporting framework.

At this point it is worth drawing a distinction between 'securities lending' and 'margin lending'. Margin lending is a practice whereby banks loan money to customers to purchase shares, on the assumption that stock prices will rise.[5] In a typical margin lending arrangement, a customer will deposit some cash and/or shares into their account and will borrow an additional amount from their lender at a pre-agreed interest rate to invest in additional shares. The proportion of their loaned amount to the overall value of the shares in their margin account is known as the loan-to-value ratio (LVR) and banks stipulate that customers must maintain the LVR below a certain level. If share prices rise, customers may borrow more money (up to a prescribed limit) to purchase shares and the customer will profit if the price rise exceeds the interest on the loan. Should the price fall, however, and the LVR exceeds the prescribed limit, then the customer must meet a so-called 'margin call', which, in practice, means depositing more cash and/or selling shares (thus crystallising a trading loss). In many margin-lending agreements, the lender has the right to close out the account, selling the shares at current (ie deflated) market values and returning back to the margin account holder any cash remaining after recovering the original loan and any fees outstanding.

Opes Prime

Opes Prime Stockbroking Limited was founded in 2003 in Melbourne, Australia as a specialist securities lending and margin lending broker. The company was founded by, among others Mr Lirim (Laurie) Emini, a securities lending expert who at one time had been a senior executive at ANZ.

Opes Prime acted as a 'broker', lending money to its clients in return for shares, similar to a margin lending arrangement, but with the crucial difference that ownership was transferred to Opes, using a modified agreement based on the standard Australian Master Securities Lending Agreement (AMSLA). In turn, Opes parcelled up these shares and then loaned them on to larger securities lenders, including ANZ and Merrill Lynch, in return for cash, which it used to borrow more shares, and so on. In effect, Opes was acting as a market intermediary, making its money on the additional spread that it could charge its clients over that charged to them by ANZ.

At this point it should be noted that there are several legal cases concerning ANZ and Opes pending in Australian courts and that the issues described here are still subject to some debate. In particular, there have been numerous articles in the Australian press reporting (often disputed) activities by Opes directors. While such activities may have had a bearing on the collapse of Opes, they do not directly impact consideration of internal problems within ANZ and hence will not be discussed in detail in this paper.

Market volatility

Figure 1 shows the conditions in the financial markets that eventually

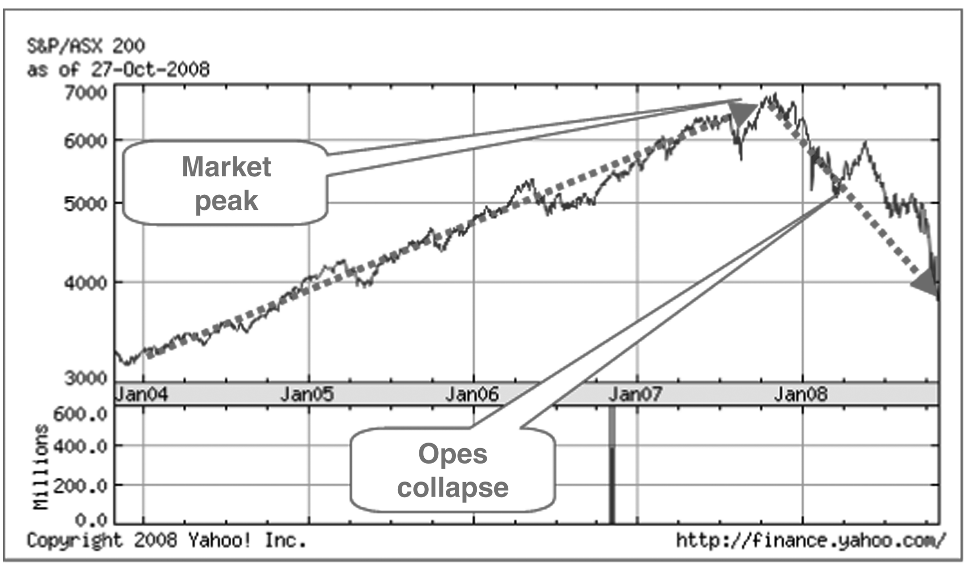

Figure 1: Five-year history of the S&P ASX 200 stock market index

precipitated the collapse of Opes and other Australian companies. For four years from January 2004, there was, as in many other markets in the world, a spectacular 'bull market' in the Australian stock market, as illustrated by the major market index, the Standard & Poor's ASX 200. In mid-2007, serious problems in the US financial markets, which have become known as the 'credit crunch', began to affect stock markets around the world and, in November 2007, the ASX market index hit its peak. From that point, stock prices began to fall, dropping some 20 per cent from November 2007 to March 2008.

The scene was set for the events that precipitated the failure of Opes Prime in late March 2008.

ANALYSIS OF DISASTERS

Turner's framework for disasters

In an often-cited work in decision literature, Turner[1] examined the official reports of a number of 'disasters' from an organisational perspective. The disasters analysed by Turner resulted in considerable loss of life and so cannot be compared with the failures of management that were apparent at financial institutions. However, Turner considered that discussion of such disasters offers 'a paradigm for discussion of less tragic but equally important organisational and inter-organisational failures of foresight', such as significant financial losses at a major public company. Turner identified a number of 'stages' in the 'development of a disaster' and 'features' that appear to be common to them, which are summarised in Table 1.

Turner's framework provides a useful tool for analysing the ANZ case (and others) because, as with the disasters that Turner studied, an official inquiry was conducted into the events leading up to the losses, the results of which were published by the bank.[2]

Turner's framework concentrates on the stages of 'initial beliefs' and 'incubation' because he argued that it was *before* the onset of disasters that the significant organisational failures tended to occur. In an observation that is important for banking regulators and management, Turner pointed out that:

> 'Disasters, other than those arising from natural forces, are not created overnight. It is rare that an individual, by virtue of a single error, can create a disastrous outcome in an area believed to be relatively secure. To achieve such a transformation he or she needs the unwitting assistance offered by access to the resources . . . of large organisations, and time.'[1]

Financial disasters

A number of well-publicised 'financial disasters' have been attributed to deficient operational risk management, in particular the losses due to 'rogue traders' which caused the collapse of Barings Bank and significant losses at National Australia Bank (NAB), as documented by Crouhy *et al.*[6] and McConnell.[7–9] McConnell[8] has also described losses due to rogue trading at Allied Irish Bank (AIB) in terms of the Turner framework.

In January 2008, Société Générale SA, France's second-biggest bank, announced that a relatively junior trader, Jerome Kerviel, had lost €4.9bn ($7.4bn) by taking positions on European stock market indexes and then falsifying

Table 1: Common features in the development of a disaster

Stage	Features common to disasters
1. Initial beliefs and norms Culturally accepted beliefs and precautionary norms and procedures	Failure to comply with existing regulations
2. Incubation period The accumulation of an unnoticed set of events which are at odds with the accepted beliefs	(a) Rigidities of belief (b) Decoy phenomena (c) Disregard of complaints from outsiders (d) Information difficulties and noise (e) The involvement of strangers (f) Failure to comply with discredited or out-of-date regulations (g) Minimising emergent danger
3. Precipitating event The event that forces itself to public attention	
4. Onset The immediate consequences of the collapse of 'cultural precautions' becomes apparent	
5. Rescue and salvage The immediate post-collapse situation when rescue attempts begin	
6. Full cultural adjustment An inquiry is carried out and beliefs are adjusted	The establishment of a new level of precautions

Source: Turner, B. (1976) 'The organisational and interorganisational development of disasters', *Administrative Science Quarterly*, Vol. 21, No. 3, pp. 378–397 (Tables 1 & 2, pp. 381 & 391).

documents and e-mails to pretend the bets were hedged.[10] Kerviel was initially arrested but quickly released, however, claiming, and continuing to claim, that the company was aware of his actions and hence had concurred.

Under pressure from the Banking Commission of the Banque de France, the French financial regulator, Société Générale set up a formal inquiry to investigate the events leading up to the losses, which released its final report in May 2008.[11] Unlike AIB and NAB, however, the Société Générale inquiry is somewhat compromised because it was conducted by a 'special committee', consisting of 'independent' directors of the board, with the support of internal audit. The inquiry did call upon PricewaterhouseCoopers (PWC) to assist in the inquiry but only to assess the proposed changes to risk management within the organisation.

While the inquiry continued to refer to the events as a 'fraud', its report gives details of a litany of failed opportunities to detect the fraud over a prolonged period of time, many attributable to the fact that, while control staff did raise issues with the trader and his superiors, they did not follow up on answers/excuses that were given for 'red flags' being raised. The conclusion was that the procedures in place were sufficient to indicate the possibility of a problem, but more controls were needed to bring it to management's attention.

However, precisely the same reasons were proffered in other cases of large-scale and well-publicised losses due to fraudulent trading, such as Barings, AIB and NAB, so, given the publicity given to other losses, there is no real excuse for the control failures that occurred at Société Générale.

The APRA report into the NAB failure highlights the importance of in-depth analysis of organisational disasters: 'the wisdom of hindsight provides a valuable platform from which to learn lessons for the future'.[3] The analysis in the present paper attempts to contribute to an understanding of the events at ANZ, and similar situations, using Turner's framework.

ANZ: DEVELOPMENT OF A DISASTER

The onset of disaster

Turner[1] identifies two distinct stages that bring a disaster to the public's attention: the 'precipitating event', which grabs the attention of the public; and the 'onset', or immediate consequences of the event.

The precipitating event

On 27th March, 2008, Opes Prime Group Limited was placed into voluntary administration by its directors and, as a result, was suspended as a participant on the Australian Stock Exchange (ASX). In announcing the appointment of receivers, Opes directors stated that:

> 'They became aware of a number of cash and stock movement irregularities in relation to a small number of accounts [leading directors to believe that] trading operations could not continue. These matters will continue to be subject to the receivers' investigations.'[12]

On the next day, the Australian Securities and Investments Commission (ASIC), the Australian corporate regulator, announced an investigation into 'any potential breaches of the Corporations Act', following up a few days later in successfully petitioning courts to prevent three Opes directors from leaving the country.[13]

While Opes Prime had operated as a broker with a number of large banks, its main relationship was with the ANZ bank, which, in a formal statement to the market on the collapse of the company, stated:

> 'Following the appointment of a voluntary administrator by the directors of Opes Prime Group Ltd and the subsequent appointment by ANZ of receivers, ANZ today advised its lending exposure to Opes Prime [later estimated at A$650m] was supported by security in a portfolio of Australian equities . . . The portfolio is diversified and at current market prices is sufficient to cover the amount outstanding from Opes Prime. ANZ believes that based on an orderly realisation of the security portfolio, *it is unlikely to incur a material loss on this exposure*' [emphasis added].[14]

The onset

The collapse of Opes Prime generated immense interest in the local Australian media, in part because a number of high-profile celebrities were clients of the firm and the collapse was part of an emerging phenomenon of firms experiencing severe difficulties due to the deteriorating conditions in the credit markets, ie the so-called 'credit crunch'.

The problem was compounded when both the Opes receivers and ANZ began to sell shares in the market to cover the loans made, leading several Opes clients, in turn, to suspend trading because they had lost access to their share portfolios held with Opes.

In early April 2008, a class action on behalf of a number of Opes clients petitioned the Australian Federal Court to prevent the Opes receivers and ANZ from selling shares, claiming that they had been misled as to the title/ownership status of the shares lodged with Opes.[15] In early May 2008, the court rejected the request to stop selling shares, thus confirming ANZ's rights in selling the shares deposited by Opes under the lending agreement between Opes and ANZ. In welcoming the judgment, ANZ stated that, 'ANZ would continue with its orderly sell down of shares in order to realise fair and reasonable value for its Opes Prime portfolio'.[16]

In reaction to adverse publicity, on 12th April, 2008, ANZ announced a review of the bank's involvement with securities lending, in general, and Opes Prime, in particular. The review was not independent but was conducted by an internal review committee led by the CEO, Mike Smith, and four directors and senior managers, supported by internal staff and external consultants. The aim of the review was 'to address the legitimate expectations of ANZ's shareholders, its customers and the wider community, that the way in which ANZ conducts its business should meet the highest standards of ethics and business practice'.[2]

The report of the review was published on 22nd August, 2008 and forms the basis for the information presented in this paper. Ideally, as in the case of the NAB failure, an inquiry conducted by an external party would provide an independent perspective, but the ANZ review appears to have attempted to get to the source of the problems and is fairly transparent about the failings within the company. Naturally, this paper has no access to any information as to whether the faults found in securities lending were apparent elsewhere in the firm, which would have been provided by an independent inquiry. Nor, unfortunately, due to ongoing litigation, is there a detailed description of the wider relationship between ANZ and Opes, such as the extension of credit to the broker in the final months of its existence.[17,18]

Initial beliefs and norms

Turner argues that a disaster or 'cultural collapse' takes place because of 'some inaccuracy or inadequacy in the accepted norms and beliefs' of a firm.[1] 'Organisational disasters build up gradually over time and the signs should be apparent to management. Instead, the warning signs go unnoticed or ignored because of "cultural rigidity", which manifests itself in erroneous assumptions and reluctance to face unpalatable outcomes'.[1]

A clue as to the 'initial beliefs' in ANZ as regards equity finance can be seen in the attitude of the bank and its external auditor, KPMG, which:

> 'Did not conduct detailed audits of the ANZ custodian services business (including the ANZ securities lending unit) in the course of their annual audit as these businesses did not fall within *the materiality criteria* applicable to those external audits' [emphasis added].[2]

In other words, custody (and by implication securities lending) was considered a 'low-risk' business. In a purely financial sense, a securities lending business *is* low-risk, *provided that operational risks are under control*, in particular, provided that legal agreements are watertight and collateral is managed properly (ie credit risk is actively controlled).

Because it is low-risk, securities lending by its nature is also low-return, making money on fees for service and minuscule margins on lending between the owners of securities and borrowers. However, such a business can only be profitable in the long term if it is efficient; in particular, it must develop a technology infrastructure to handle transactions at lower costs than its competitors.

The incubation period

Turner has identified several 'features' that are common to disasters, from organisational rigidity to individual failure to appreciate danger.[1] He argues that disasters tend to occur not as a result of some sudden event, but as a consequence of an accumulation of organisational and individual faults that cause a problem, which could have been contained, to grow into a catastrophe. Turner argues that 'small scale disasters can be produced rapidly, but large scale disasters can only be produced if time and resources are devoted to them'.[1]

During the incubation period of a disaster, Turner points out that there is a steady accumulation of events that are at odds with the norms of the organisation but go unnoticed because their importance is not fully appreciated. It is the gradual acceptance of such events that blinds management to potential problems. The ANZ review identifies the same tendency to 'accept the unacceptable', over time.[2]

The ANZ review notes how the bank had been involved in securities lending since the mid-1980s, operating in different business units of the bank until 1999, when it was moved into the custodian services business line, a part of the institutional division.[2] Although previously undertaken on a small scale, equity finance, as a distinct product offering, emerged in late 2001. Interestingly, the review notes, 'there is no record that any initial product approval was sought or obtained with respect to the equity finance product', and that within the securities lending business unit, equity finance was often referred to as 'reverse stock lending', ie the new product slipped in under the radar.

In 2002, the institutional wholesale credit risk unit developed a specific 'securities lending policy', which, although not stated explicitly, was interpreted by custodian services as permitting equity finance. By mid-2005, however, the business had grown from a total financial exposure of A$33m in 2001 to A$771m, a 20-fold increase. This was not done in a vacuum, as the 'ANZ securities lending unit was given freedom and encouragement by management of ANZ custodian services to grow the equity finance business'.[2]

In 2005, a formal credit risk assessment of the equity finance business found that no credit risk limits were in place for its 'broker' customers, such as Opes, even though there was significant credit risk, and recommended that '*no further expansion of ANZ's equity finance activities be undertaken* and that credit limits be imposed with respect to the brokers with whom ANZ had existing equity finance arrangements' [emphasis added].[2]

However, while no new customers were accepted, development of full credit risk limits for all brokers took over 12 months to approve, even though financial exposure on most brokers 'more than doubled between the date of the [assessment] and the date on which credit limits were eventually imposed'. Obviously, credit risk for the brokers with whom they dealt was not considered an important issue by business unit management, and growing the business was more important. The review notes that, 'controls on the overall size of the business were often exceeded in the apparent belief by relevant line and risk management that retrospective approvals could be easily sought and obtained'.[2]

The review committee admitted that such a situation was unacceptable:

> 'In hindsight, ANZ's equity finance business should not have operated in an environment where all the risks were not fully understood and managed. *The business posed unacceptable reputational and financial risks* to ANZ and these were not properly identified' [emphasis added].[2]

The question then is: if the situation was clearly unacceptable, why did ANZ management not detect and fix the problem before it got out of hand?

Turner identifies the 'incubation period' as the stage where the 'failures of foresight' that lead to the eventual disaster occur.[1] He describes a number of key features (summarised in Table 1) common to the disasters he studied. These features are discussed below in the context of the ANZ case.

Rigidities of belief

According to Turner, all organisations develop a culture that relates the tasks that individuals perform to the goals of the firm, and success stems from the effectiveness of this culture.[1] The other side of this coin, however, is that in attempting to create an all-pervasive culture, managers may well become blind to potential problems.

As in the NAB case,[9] there was a culture of 'management by committee' in ANZ:

> 'There was a lack of individual accountability within the line and risk management responsible for the equity finance business, with responsibility for many decisions resting with committees. This was compounded by deficiencies in the structure and management of the relevant committees.'[2]

One committee in particular, the securities lending oversight risk committee (SLORC), was deemed to be at fault. In a particularly scathing comment, the review committee noted that SLORC did 'not have a clearly defined role within ANZ's risk framework', had been set up with no formal delegation authority and in its '*self-appointed*' role was not effective because, in its formal meetings, it 'discussed and considered a wide range of risk and other matters relating to the ANZ securities lending unit, *but did not proactively manage issues raised with it*' [emphasis added].[2]

In effect this risk committee was overseeing itself, the report concluding that, 'reliance by the line and risk management responsible for the ANZ securities lending unit upon SLORC *constituted an abdication of individual responsibility* by the persons with whom that responsibility should properly reside' [emphasis added].[2]

In short, provided that bureaucratic processes were seen to be followed (a so-called 'tick box' culture), all would be well. This echoes the culture of NAB as documented by APRA:

> 'NAB's internal governance model, which should have enabled timely identification and effective and quick escalation of serious risk issues on the currency options desk, simply did not function. That this could occur is symptomatic of *an organisational culture that did not have sufficient regard to the risks attendant with these products*' [emphasis added].[3]

In retrospect, ANZ's management appear to be victims of exactly the same sort of management myopia that led to the problems at NAB.

Disregard of complaints from outsiders

Perhaps one of the most surprising findings in the disasters reported by Turner,[1] McConnell,[7–9] Gleick[19] and Augustine[20] is the volume of clear warnings in the run-up to the disaster. However, such warnings from outsiders were routinely dismissed by management, on the apparent assumption that these 'outsiders' did not have as good an understanding of the firm's business as those working within the firm. The same 'organisational exclusivity'[1] was apparent within ANZ.

In a section entitled 'Failure to identify warning signs' the ANZ review specifically noted that:

> 'Various concerns were raised on an ad hoc basis by line and risk managers, generally with their peers and immediate superiors . . . and with credit risk and market risk managers. These concerns related to the processes, personnel and systems used in the equity finance and standard securities lending businesses and the *risks associated with these businesses*. The issues that were identified were not consistent with good banking practice and *should have prompted further investigation and scrutiny*' [emphasis added].[2]

The review also reported that ANZ's internal audit had given the securities lending unit 'adverse' and 'seriously adverse' ratings for three years from 2005, a view supported by PWC in late 2007, which identified 'significant control issues in relation to the businesses'.[2]

The ANZ review concluded that:

> 'Management did not appear to place sufficient focus on the adverse internal audit ratings for the ANZ securities lending unit and did not take sufficient, timely and appropriate measures to remedy the underlying issues which were the cause of those adverse ratings *although they reported to the audit committee that remedial actions were being undertaken*' [emphasis added].[2]

In the NAB case also, APRA noted that the bank's external auditors had repeatedly warned senior executives about serious 'three-star' issues raised by internal audit but that 'there was inadequate response by management about these points and the timeframe for completion was allowed to slip'.[3] Even though they were well aware of the problems identified by its banking regulator at NAB,[21] it is obvious that ANZ management did not fully address similar issues within the company's own culture.

Information difficulties and noise

Turner pays particular attention to the problems that arise within and between organisational groups, highlighting the fact that information about a potential disaster is often widely available but is not communicated to those who may need to know it.[1]

In a section entitled 'Knowledge of the board', the ANZ review notes that:

> 'Between 1999 and February 2008 (ie when serious concerns with some of the brokers became apparent), papers presented to the board and the risk and audit committees included only occasional references to the securities lending business [and] a small number of references that included the words "equity finance" or "equity financing"'.[2]

The ANZ report also notes that:

> 'The board, relevant board committees and the chief executive officer were *not provided with a clear understanding* of ANZ's potential exposures in respect of the equity finance business. [Furthermore ...] The gravity of the issues relating to the equity finance business should have been, but were not, properly brought to the attention of the chief executive officer and board [emphasis added].'[2]

Part of the reason for this lack of 'clear understanding' by the board and senior management was the fact that the equity finance business 'did not initially apply credit limits to its customers' and hence these risks were not 'visible' to the board. However, as a result of a formal credit risk assessment in 2005, the decision was taken to implement credit risk limits for brokers but 'when credit limits were eventually applied they were calculated on a [10 per cent] "potential exposure" [rather than fully funded] risk basis'.[2] This was obviously a case of too little, too late.

On the few occasions when credit limit excesses were reported, the excess reports to the board underplayed the importance of these breaches, among many others, as [merely?] 'resulting from custody "stock borrowing" activities'.[2]

The ANZ review committee considered that the basic 'lack of understanding' about equity finance was at the heart of the information problems:

> 'The lack of understanding led to errors and omissions in upward reporting of relevant issues. In some instances, *incorrect information* was provided ... In particular, CTC [the credit and trading risk committee] was *not provided* with all information required by it to properly consider the matters submitted to it in relation to the equity finance business [emphasis added].'[2]

Turner warns that a large number of 'messages', many of which are just 'noise', are generated in large organisations, which offers the 'opportunity for failures of communications to develop'.[1] This too was apparent at ANZ in this case.

The involvement of strangers

Turner refers to 'strangers' as members of the general public who may behave unpredictably in a disaster.[1] In the Barings, AIB and NAB cases, McConnell[7–9] has identified examples of 'strangers' in the banking industry, in particular brokers, that had an impact on those events and this phenomenon is also obvious in the ANZ case.

Brokers play an important intermediate role in financial markets, using their contacts to match buyers with sellers and earning a fee for doing so. It is a vital role but one which can be open to abuse. For example, brokers sometimes cultivate clients using lavish entertainment and none too subtle inducements to trade, such as providing free access to major sporting events.

In one respect, Opes was not a 'stranger' to ANZ, its CEO, Laurie Emini, had headed up the securities lending business at ANZ in the 1990s, among other senior executive roles at the bank. The review noted that Mr Emini had 'worked with, and was a friend of, some members of ANZ's securities lending unit'.[2] While there is no evidence that Mr Emini, in his dealings with ANZ, used his personal contacts and extensive knowledge of ANZ's equity finance business and processes in an unethical manner, he was obviously able to use his deep knowledge of the bank's internal deficiencies to the advantage of Opes.

In one of a series of articles provocatively titled 'Web of deceit' by the *Business Spectator* in Australia,[17,18] a very close relationship between ANZ and Opes is described. The article notes, for example, that the ANZ logo was prominently displayed on the Opes website, presumably attempting to imply a close relationship to reassure Opes clients. It also reports that, in early March (ie *before* Opes failed) ANZ had been having discussions with Opes directors on how to terminate the relationship because they were 'exiting the business'.[17,18] Such a change in strategy would have a profound impact on Opes, as ANZ was its major lender, and according to the *Business Spectator*, ANZ was prepared to lend around A$95m to Opes to cover problems that had been identified 'but only in return for a debenture charge over the whole group'.[17,18]

In Turner's framework, 'strangers' may not necessarily contribute directly to the causes of disasters, but become part of the 'noise' that hinders the detection of potential problems. In this case, the relationship between ANZ and Opes, which should have been detached, appears to be overly close and may have contributed to potential problems being minimised.

Failure to comply with discredited or out-of-date regulations

Turner notes that failures to do what is right do not usually happen in isolation but arise from a culture of failing 'to comply with discredited or out-of-date regulations'.[1] This, as with NAB,[9] was also true of ANZ.

In a section headed 'Deficiencies in the securities lending policy', the ANZ review reports that a specific policy on securities lending was issued in 2002 but was only amended to cover equity finance in mid-2006, by which time the business had grown some 20-fold. The report noted that, 'this growth *should have* prompted a thorough review of the risks associated with the business and the adequacy of the policy. Instead, later policies simply built upon the earlier policies *on a piecemeal basis*' [emphasis added].[2]

After the 2005 credit risk assessment, new controls were introduced to the equity finance business but implementation of the controls took an 'unacceptably long time to be implemented, in particular controls requiring the funding to a broker to be reduced or the types of securities to be accepted from a broker to be limited'.[2]

In the meantime, the controls were just ignored:

> 'Where a new credit limit was less than the current exposure to the broker, the ANZ securities lending unit did not stop

> accepting securities and continued to provide funding. These excesses were generally only brought under control when higher credit limits were approved for the brokers.'[2]

The securities lending policy itself was clearly discredited and not complied with fully, as noted by the review committee:

> 'The securities lending policy [as amended in 2006] is not of an appropriate standard. It is not structured in a logical manner and does not apply relevant principles in a systematic way to the various securities lending products offered by ANZ.'[2]

The ANZ report also notes that there was a culture of failing to comply with this policy: 'With an absence of processes to measure compliance with relevant controls and the fact that *no disciplinary measures were imposed* if a policy or approval was not followed' [emphasis added].[2]

Another example of ANZ failing to comply with regulation was its failure to adhere fully to Australian corporation law, which requires anyone who acquires more than 5 per cent of a company to disclose that holding to the corporate regulator, ASIC, in a 'substantial shareholding notice'. It transpired that ANZ, at the time of the Opes collapse, had held a 26 per cent interest in a small company (BioProspect) but, because of inadequacies in processes and systems, had not notified ASIC of that ownership.[22]

In the course of hearings by the Australian Takeovers Panel,[22] ANZ claimed that, because the holding was acquired under a special 'current relief' order issued by ASIC covering 'equity financing' transactions, it did not have to be disclosed. In evidence presented to the panel, however, ASIC submitted that, ANZ 'cannot rely on the current relief in respect of securities lending transactions carried out under an AMSLA with Opes'.[22] Unfortunately for ANZ, the Takeovers Panel agreed with ASIC, concluding that, in effect, ANZ was in breach of takeover regulations and had been for some time, releasing data that showed that at the time of the Opes failure it had held interests above the 5 per cent reporting level, in a number of companies.[22] As with many legal issues, the rules on takeovers are mind-bogglingly complex, relying on definitions that are rarely, if ever, tested in court; this may mean that such regulations become, in Turner's terms, 'discredited'.

Turner suggests that ignoring 'discredited or out-of-date policies' is especially problematic because there is an appearance of full compliance with policies, giving management 'false confidence' that all is well.[1] Coupled with the lack of good information flowing to those managers who have the power to act, potentially serious problems can fester until there is a disaster.

Minimising emergent danger

Turner points out that a common feature of organisational disasters is that those who are closest to the problem 'fail to call for help', which has been attributed to fears of causing unnecessary alarm, psychological denial of the danger, or an assertion of the individual's invulnerability.[1] Turner adds that individuals consistently underestimate the scale of the problems that they face because of ambiguity or disagreement about the evidence of the danger. He also notes that when the danger becomes impossible to ignore, rather than address the causes of the problem, individuals often look to shift the blame to others.

Throughout the ANZ review report, there are repeated references to the inability of the securities lending unit to properly address the credit risks in its equity finance business. The core problem seems to have been the difficulty/inability to quantify an appropriate LVR on securities borrowed from brokers, such as Opes.

To address these problems, a new LVR model was proposed; however, presumably because the risks/dangers were being underestimated, this new model was not implemented until March 2008, just prior to the failure of Opes. In itself, this may not have been too problematic, except for the fact that by mid-2007 the business had grown to A$2bn advanced to brokers, ie a 'potential exposure' of some A$200m, a huge sum given the capitalisation of the brokers involved.

However, management was unaware, or ignored, the growing problems. The review reports that 'even as late as September 2007 . . . executives provided comfort in a written report to the risk committee about the control environment in certain parts of the institutional division, including ANZ custodian services'.[2]

Obviously the ANZ risk committee was not sufficiently proactive in searching out problems. In the NAB case too, warning signs were apparent, but the growing dangers were consistently underestimated as identified by APRA:

> 'If the members of the [NAB] risk management committee had acted on the warning signs before them — for example, by commissioning a targeted review of known control weaknesses by internal audit — the irregular trading *would surely have been discovered*' [emphasis added].[3]

The ANZ review report does not provide any commentary as to why the management may have been blind to problems, but in other situations, remuneration and bonuses based on business profitability may have been, at least partially, responsible. In its report of the NAB case, APRA provides a clue as to what may have occurred at ANZ, suggesting that 'line management turned a blind eye to known risk management concerns. "Profit is king" was an expression frequently heard in [the inquiry's] interviews with staff. As long as the business unit turned a profit, other shortcomings could be overlooked'.[3]

After the event

Turner identifies two final stages that are common in an organisational disaster: in the immediate aftermath there is the 'rescue and salvage' of anything of value left from the disaster and finally there is the 'cultural adjustment', which attempts to learn lessons from the unhappy events.[1] Again, these stages were apparent in the case of ANZ.

Rescue and salvage

The ANZ review identified a number of 'failures and deficiencies', including:

> '(a) Lack of understanding of the distinction between equity finance and standard securities lending;
>
> (b) Growth in initial business not widely known;
>
> (c) Lack of a proper control environment;
>
> (d) Poor accountability and "management by committee";

(e) Failure to identify and act on warning signs;

(f) Failure to report relevant issues to the chief executive officer and board; and

(g) Breaches of ANZ employee conduct policies.'[2]

Unlike the NAB and AIB cases, ANZ did not attribute the problems to rogue traders or unethical activities on the part of its staff, specifically stating that the review 'did not find any fraud or criminal behaviour on the part of any ANZ employees'. However, the report did note that some staff had breached 'code of conduct' policies, in particular, 'five ANZ staff held, or had access to, trading accounts with Opes and some staff traded on those accounts immediately prior to the appointment of receivers'.[2] As these transgressions were relatively minor, some of the staff involved were reprimanded, while two staff, whose accounts 'were not properly maintained', were fired. In addition, a number of managers, including senior executives, were asked to leave the company.

In addition to minor disciplinary actions, the review identified 13 'remediation activities' that were endorsed by the board, in particular, recommending that the bank should 'exit the equity finance business'.[2]

The review identified the serious damage to ANZ's reputation caused by a lack of understanding, by Opes clients, of the legal implications of the agreements that they had signed with their broker:

> 'While clients of brokers are understood to have signed agreements providing for the transfer of ownership of securities, when [Opes] becomes insolvent, ANZ is seen to be, and in fact is, holding the securities that [Opes] clients may have expected would be returned to them. In realizing these securities to protect its position, ANZ is regarded by some (including clients of [Opes]) as *acting in its own interests* and at the expense of the clients of the broker' [emphasis added].[2]

Cultural adjustment

Turner points out that, after the dust settles, it is possible to carry out a 'more leisurely and less superficial assessment' of the events leading up to a disaster, with the goal of learning lessons from it and ultimately closing the circle by adjusting the erroneous beliefs and norms that led to the failure.[1] In its report into the NAB affair, APRA is in strong agreement with Turner's viewpoint:

> 'APRA believes that cultural change must be driven from the top . . . the cultural issues thrown up need to be treated with the *same attention and seriousness* as the technical and operational breakdown. APRA requires that the board undertake a review of cultural norms within NAB and, following this, clearly articulates the standards of behaviour, professionalism and openness it expects of the organisation' [emphasis added].[3]

Many of the 'remediation activities' recommended by the ANZ review relate to tightening policies, in particular credit risk, code of conduct and product approval policies; improving reporting of credit risk exposures; improving training of senior executives; and interestingly, implementing 'a new reputation risk framework to establish formal policy and accountability across ANZ for management of reputation risk'.[2]

As of the end of 2008, little information on the details of the reputation risk framework had been released by ANZ, other than that a specialist reputation risk committee had been set up to be 'responsible for the development of strategies and policies to assist reputation risk management, corporate responsibility awareness and corporate governance'.[2]

As with any firm-wide cultural change/adjustment, ANZ's reputation risk framework will take some time to implement across the firm and hence its success, or otherwise, in changing the 'beliefs and norms that lead to failure'[1] will not be measurable for several years.

TURNER'S FRAMEWORK: OPERATIONAL RISK FAILURES

Turner's framework: Summary for ANZ

Turner's work identifies several common factors in what he terms 'organisational disasters' and he has developed a framework for analysing such disasters.[1] Turner argues that the seeds of organisational disasters are sown well before the 'precipitating event' brings the problems to the public's attention. In particular, he argues that the major problems arise because there is 'some inaccuracy or inadequacy in the accepted norms and beliefs' of the firm in which the disaster occurs.[1]

The above sections use Turner's framework to analyse the losses at ANZ following the collapse of Opes and conclude that:

- the fundamental belief that securities lending was a low-risk business led line managers and executives to underestimate the problems that could occur if one of the company's large customers defaulted (ie a lack of understanding of the 'credit risks' in the business);
- when this belief was challenged, the business line managers and their superiors were slow to introduce the necessary risk frameworks and policies, and once implemented, did not ensure that the relevant policies were complied with (ie a lack of understanding of the 'operational risks' in the business);
- managers assumed that all of the legal agreements covering securities lending were watertight, which was proven incorrect (ie a lack of understanding of the 'legal risks' in the business);
- in the bull stock markets of the early 2000s, managers grew the equity finance product without investing in the necessary technology support to make the business sustainable (ie a lack of understanding of the 'systems risks' in the business);
- in their pursuit of growth in market share, managers and executives did not inform the board of the attendant risks, nor did the risk committee proactively seek out such information, even in the light of external warnings that they should do so (ie a lack of a comprehensive 'risk culture').

While, in the end, the losses were precipitated by failure to manage credit risks, in that the value of the liquidated stock borrowed from Opes did not cover the money lent to Opes,[23] it was the failure of fundamental banking processes, inadequate systems and, to a minor extent, staff misdemeanours that led to the losses, ie this was an operational risk event as defined by Basel II.

The framework for analysing disasters developed by Turner[1] may be used to compare the organisational problems giving rise to a number of well-documented operational risk failures, such as those identified in Table 2. The table compares the cases described above[2,8,9,11] in terms of the Turner framework and 'other factors', such as the impact of bonuses and deficient risk technology, which have been identified as potentially influencing these cases although they are not specifically addressed by Turner.

Table 2: Summary of common features in the development of a disaster (selected cases)

Feature	ANZ Bank	National Australia Bank	Allied Irish Bank	Société Générale
(a) Rigidities of belief	Equity finance was 'low risk' and 'not material'	Most advanced FX options operation in market	FX arbitrage was 'low risk'	Equity arbitrage was 'low risk'
(b) Decoy phenomena	Broker (Opes) familiar	Focus on process rather than content	Budget constraints	Profit smoothing
(c) Disregard of outsider complaints	Adverse audit reports	Market participants and auditors	Market participants	Market operator (FIMAT)
(d) Information difficulties and noise	Board and management not informed of risks	Risk committee overworked	Information suppressed by line management	Risk information 'missing'
(e) The involvement of strangers	Unethical brokers	Unethical brokers	Unethical brokers	Internal broker
(f) Failure to comply with discredited or out-of-date regulations	Ignoring securities lending policies, retrospective approvals	Missing trade confirmations, inadequate reconciliation	Missing trade confirmations, inadequate reconciliation	Ignoring trading policy
(g) Minimising emergent danger	Credit limit excesses ignored	Market limit excesses ignored	Back office warnings ignored	Credit limit excesses ignored
Other factors				
Markets	Margin lending	FX options	FX	Equity derivatives
Distance from HQ	Close	Close	Remote	Close
People issues — bonus driven	Not reported	Yes	Yes	Yes
People issues — bullying/ aggression	Not reported	Yes	Yes	Not reported
Risk technology issues	Inadequate reporting systems	Inadequate systems, easily circumvented	Inadequate systems, easily circumvented	Inadequate systems
Audit concerns	Not addressed promptly	Downgraded	Ignored	Not addressed promptly
Risk management — organisation	'State of the art'	'No confidence'	'State of the art'	'State of the art'

OPERATIONAL RISK MANAGEMENT

The breakdown of controls at ANZ illustrates a failure in the management of operational risk. It is also worrying that, in spite of the regulations, instituted after the failure of Barings and adopted as 'best practice' by NAB[3] and AIB,[24] similar failures of operational risk management have occurred.

The Basel proposals

In 2004, the Basel Committee of the Bank for International Settlements, the world's senior banking regulator, finalised proposals[25] to bring the management of operational risk in line with the standards already adopted for market and credit risks. These so-called Basel II proposals are designed to strengthen operational controls in international banks and to ensure that they have set aside sufficient capital to cover large losses, such as those at NAB and ANZ.

The Basel Committee defines operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition *includes legal risk but not strategic or reputational risk*' [emphasis added].[25]

While the ANZ review goes to great lengths, rightly, to emphasise the impact of the Opes collapse on its 'reputation', it is obvious that the factors identified by the Basel Committee as giving rise to operational risk were all present in the ANZ case:[2]

- *processes:* basic operational processes, particularly in managing credit risk, were deficient at ANZ;
- *people:* until 2008, management appeared to condone unacceptable behaviour, such as breaches of the bank's code of conduct in managing external trading accounts;
- *systems:* credit risk and collateral management systems were deficient; and
- *external:* the behaviour of brokers, especially Opes, precipitated the losses.

In particular, the ANZ review[2] highlights deficiencies in 'processes' at all levels of ANZ, including:

- *operational:* non-adherence to published lending control policies, which was a major contributing factor to the disaster;
- *risk management:* the failure to properly manage credit risk limit excesses;
- *financial:* the failure to set adequate collateral levels, relying instead on a fixed 10 per cent of transaction value;
- *systems:* the inability of systems to properly accommodate LVRs for illiquid securities;
- *audit:* the failure to properly follow up the resolution of important audit issues; and
- *strategic:* the failure of senior management to evaluate the rewards and risks in securities lending, letting the business continue long after it had been assessed as unsustainable.

In particular the lack of appropriate procedures to ensure that controls were enforced was apparent at all levels in ANZ and was a major contributing factor to the disaster.

McConnell[9] and Ludwig[24] document the same set of deficiencies in the NAB and AIB cases, even though the events that precipitated those losses were very different. Following Turner's analysis, it is argued here that, whereas the failures in the cases of ANZ, NAB and AIB may arise from different 'causes', it is the underlying management failures that create the environment where financial disasters, occasioning large losses, can occur. Clearly those failures must be addressed by financial regulators and risk managers in the context of operational risk management.

LESSONS FOR OPERATIONAL RISK MANAGEMENT

If, as argued in this paper, Turner is correct in asserting that many spectacular operational risk loss events, such as ANZ, NAB and AIB, must be viewed as resulting from management failures that should be apparent over a long period of time, an obvious question is how operational risk management functions can help to detect and minimise the impact of such deficiencies. In addition, what lessons can be learned from these failures?

If, as Turner asserts, the major problems lie in 'some inaccuracy or inadequacy in the accepted norms and beliefs' in the firm then over a prolonged 'incubation period', there will be an 'accumulation of an *unnoticed* set of events which are at odds with the accepted beliefs'.[1] The good news is that there is time; if the incubation period is long enough there should be sufficient time and opportunity to:

- question and, if necessary, rectify erroneous initial beliefs; and
- detect 'unnoticed events' that are at odds with acceptable beliefs.

The question then becomes one of finding the best way to embed the necessary questioning of potentially fallacious assumptions within the Basel II framework.

One way to achieve this is to search for the 'features common to disasters', as identified by Turner,[1] as part of the regular process of risk and control self-assessment,[26] which is suggested for banks, such as ANZ, that use an advanced measurement approach for calculating operational risk capital. In particular, special attention must be paid to identifying 'rigid beliefs' that are no longer appropriate and any 'disregard of warnings from outsiders', especially auditors and supervisors.

SUMMARY

The losses at ANZ due to the Opes Prime collapse were the result of an event that captured the attention of bankers, banking regulators and investors. Justice, in the form of an internal inquiry, was seen to be done and heads rolled. But have the lessons of ANZ (and similar events at NAB, AIB and Société Générale) really been learned?

As far back as 1976, Turner argued that 'organisational disasters' do not happen overnight, but rather are the result of organisational failures over a long period of time. This paper has analysed the reports of official inquiries into the losses at ANZ, using Turner's framework, and has argued that most of the 'common features of disasters', identified by Turner[1] were present in the ANZ case. The paper argues that Turner's work is not only useful as a forensic tool for analysing disastrous events after they have occurred, but that it also contains valuable lessons for practising managers. There is also considerable scope for updating Turner's framework to take account of new factors, such as the insidious effect of performance-related remuneration and the psychology of financial trading.

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