

# **Accountability and Board Functionality: National Australia Bank's experience**

by

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## Abstract:

The National Australia Bank's (NAB) experience of corporate governance has been contrary to current standards of good corporate governance, accountability and risk management. Over the last few years NAB's misadventures have brought it under intensive media scrutiny with the HomeSide losses and the investigation by the Securities and Exchange Commission in the USA for breaches of auditor independence. More recently the unauthorised trading by its foreign exchange dealers violated NAB's risk management practices and the subsequent board crisis resulted in significant downgrading of the share price on the Australian Stock Exchange (ASX). This paper briefly reviews the international history of corporate accountability and its growth in Australia. The increasing shareholder and legislative pressure to improve sustainability, accountability and board functionality have driven these issues to the forefront of Governing Boards' agendas worldwide. The board remains ultimately responsible for all actions of the company and this is highlighted by APRA's recent release of the new governance standard APG510 for implementation by October 2006. The impact of NAB's board dysfunction on its overall performance is compared with the other major banks in Australia. Cost efficiency ratios, share price and total shareholder return are used as measures of performance and profitability. It is clear, from NAB's recent experience, as the worst performer of all the majors, with a 19.7% fall in net profit and a cost to income ratio of 57.4% in 2004, that the NAB board needs to improve its performance and accountability to meet a sustainable increase in profitability and higher return for investors.

## Introduction

Banks are not just financial institutions; they are the foundations of any economy. The National Australia Bank (NAB) is one of the "four pillars of banking" in Australia, but during 2004 experienced what could be called NAB's *annus horribilus*. The sequence of events that appeared to be a chain reaction rather than any planned process, began with the sacked foreign exchange traders acting as the catalyst and renegade board director, Cathy Walter, as the weapon of mass destruction, to bring about major change across the organisation and a new prudential standard in regulatory oversight (Boreham, 2004).

Corporate governance has been defined as a "catch all phrase used to refer to management issues, incorporations and the mechanisms by which corporate management can be supervised and made accountable to its members, employees, creditors and the community" (Woodward, Bird and Sievers, p498, 2001). It is clear that NAB's management and board had a lack of accountability, ineffective audit procedures and board committees, which allowed the integrity of internal control structures to be breached. The board dysfunction that followed resulted in embarrassing financial losses, a significant reduction in firm market valuation and loss of credibility similar to other banking disasters (Perro, 1997). It is therefore important to consider the issues of corporate governance with particular reference to the impact on the institution concerned, to the wider banking sector, to the community, other institutions and the economy.

The NAB's recent financial and board misadventures highlighted the impact of corporate governance failure and brought the institution under intensive media scrutiny with the HomeSide losses. More recently the investigation by the Securities and Exchange Commission in the USA for breaches of auditor independence, the unauthorised trading by its foreign exchange dealers violating NAB's risk management practices and the subsequent board crisis resulted in significant downgrading of the NAB share price on the Australian Stock Exchange. The 30% decline in share price over the nine-month period in 2004 had far reaching consequences including the erosion of trust in the NAB brand name and was a reflection of poor corporate governance and accountability of NAB and its board that had occurred over the past five years (Thomson and Jain, 2006).

The last five years have been tumultuous in the history of the NAB. This paper reviews the NAB experience as follows: firstly, the paper will outline the historical development in the literature of international corporate accountability and its development in Australia over the last two decades. Secondly, the impact of NAB's board dysfunction and lack of accountability on its overall performance is assessed and compared with the other major banks in Australia over the period 2004-2005. Lastly, the causes and consequences of board dysfunction and the policy implications for corporate governance and accountability are discussed.

### **History of Corporate Accountability: A Review**

Corporate accountability, whilst as old as capitalism itself, is a relatively new concept, which implies answerability, or an obligation to answer different stakeholders, some form of enforceability, where non-compliance results in some form of penalty (Newell 2002). It also implies applicability and universality. The concept is as much about holding corporations to account but also curbing the concentration of corporate power.

Before the 1990s the words 'corporate governance' were rarely heard, but since then there has been somewhat of a revolution in the developed world with Australia taking a leading part. Changes that are taking place involve directors taking their role more seriously. Boards are accepting that they employ management and need to be accountable for their actions. The result is a more careful defining of their role and greater care taken in performing their functions and seeing that management is managed properly (Bosch 2001). This revolution has occurred in response to some of the largest corporate collapses in history and the marked change in attitude from the courts that have resulted in a considerable number of company controllers facing severe financial penalties and/or jail sentences. The most noticeable changes are the marked reduction in tenure of CEOs and non-executive directors, a sharp increase in the proportion of independent directors on boards, and substantial increase in time spent on doing board duties.

A brief history of corporate accountability in the English-speaking world is provided by Estes (1999). Estes traces the beginning of the corporate world to the formation of the East India Company in 1601 by Queen Elizabeth, to serve the interests of the sovereign and the state. Investors began the process of “auditors” to listen to the proceedings of the corporation and the results of the venture. This was a precursor of the modern day auditor. The westwards expansion of the USA resulted in towns and states giving land and reducing constraints in order to attract new and large corporations. This smokestack chasing, ultimately culminated in the late 1800s with stockholder interest being completely divorced from public interest. The stock market crash of 1929, fuelled the passage of the 1933 Securities Act in the USA, which has been administered by the Securities and Exchange Commission from 1934 (Deloitte, 2006). A similar act passed in the UK (1934), enforced the theory that corporations were now accountable only to their shareholders, often at the expense of the community and non-share holders.

In the nineteen seventies, there was an increasing movement to increasing corporate social accountability, at the behest of academics leading to the establishment of organisational working committees by various accounting bodies (Estes, 1999). Some large corporations, with Westpac being the leader in the field both nationally and internationally, have begun to acknowledge their social responsibilities and started the concept of “social reporting”. Since then the number of companies, within the top 500 Australian companies, that report annually on sustainability has doubled (Corporate Law Bulletin, 2004).<sup>1</sup> This was the precursor of environmental disclosure statements, now mandatory for any industry likely to be affecting the environment. In the last two decades, this has resulted in increased emphasis on increased transparency and accountability of corporate boards.

Traditional ‘Agency Theory’ is where the principal contractually employs an agent to perform services. For the performance of these services the principal relinquishes some of the decision-making authority to the agent, in this case the management of the firm (McColgan, 2001). Additionally, boards rely on information from the firm’s employees and delegate implementation of their decisions to their employees as well. The problem of double agency arises within all firms where different groups of people make strategic and operational decisions. It becomes significantly more challenging as firms seek to encourage innovation and entrepreneurship among their constituent units, and contributions from their knowledge workers, by devolving initiative to

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<sup>1</sup> The Australian Government's “State of Sustainability Reporting in Australia 2004” surveyed companies in the ASX top 300, the top 100 private companies and the top 100 unlisted public companies. It shows the rate of sustainability reporting by Australian companies has doubled from 57 companies publishing public environmental reports in 2001-02, to 116 publishing sustainability reports in 2002-2003. The environmental component of a sustainability report is considered equivalent to an environmental report.

them. Child and Rodrigues (2003) describe the problem of ‘multiple agency’ where different groups of people in a firm make strategic operational decisions, magnifying the problems of accountability and control. Another example quoted is that of strategic alliance formation with other firms with transfer of value chain to such firms. Therefore the agent in this case may be an insider or a direct employee/ board member of the firm or may belong to a partner firm. Williamson (1970, as quoted in Child and Rodrigues, 2003, p7) states that the board tries to overcome this by relying on output control or results. Any such firm remains vulnerable to the problem of double agency as the board relies on reports provided by top management, which in turn relies on reports provided by lower management. This is accentuated by the loss in confidence between owners and employees by takeovers, mergers and acquisitions, which result in job losses for the faceless lower management and staff. Any loss of trust amplifies the communication breakdown between the agents, or the problem of double agency.

The double agency problem requires management to gain the full support of their staff and partner firms (Child and Rodrigues, 2003). This has led to the institution of management structures that allow for increased staff (agent) participation, involvement, fostering a sense of belonging and ownership, increased transparency and fairness of controls. These can be directly translated to corporate governance policies, avoidance of breach of trust and unlawful practices (such as the forex trader breach at NAB). Like all good policies this needs to be all-pervasive: commencing with orientation of new employees, extending to the chairman of the board, paving the way for mutual monitoring, which further reduces irresponsible behaviour and breaches of corporate governance policy (Child and Rodrigues, 2003).

Governments are cognizant of the fact that there will remain breaches of corporate governance despite the best management policies. To ensure that corporate management conforms, governments and trade groups around the world have passed legislation, which needs to be adhered to, failing that financial and criminal penalties are levied. The following table provides information on the key international corporate government initiatives (for a more complete listing of the international developments in corporate governance see Thomson and Jain, 2006).

**Table 1: List of key international initiatives to increase corporate accountability**

<b>Act</b>	<b>Scope</b>
Foreign Corrupt Practices Act of 1977 USA	Elimination of bribes paid overseas
Emergency Planning and Community Right to Know Act 1986 USA	Established a toxic inventory, reduced emissions
Pension Disclosure Regulation 1999 UK	Allows for more transparency in ethical, social and environmental concerns
Corporate Accountability Tax Gap Act 2003 USA	To limit the discrepancy between book profits and the profits declared to the IRS for taxation purposes

French 2001 Parliamentary Act	Mandatory disclosure of all social and environmental issues in annual reports
King Report on Corporate Governance in South Africa 2003	Johannesburg stock exchange adopted this report on increasing corporate governance standards and accountability
Norms on Responsibilities of Trans-national Corporations and other business enterprises with regards to human rights, United Nations 2003	Corporate accountability proposal
International Standards Organisation ISO14001	Environment Management Standards
Global Reporting Initiative	Promotes sustainability for triple bottom-line reporting
Ethical Reporting Initiative	Promotes ethical standards through supply chains
Accountability AA1000	Promotes social and ethical accounting
Corporate Governance Report: Improving Competitiveness and Access to Capital in Global Markets OECD 1998	Protection of shareholders rights, equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency and the responsibilities of the board. Integrity of internal control structures and accountability, transparency and disclosure of board members and executive staff.
The Combined Code UK 1998	Requires companies to provide disclosure statement on their adherence to the principles of good governance
Sarbanes-Oxley Act US Federal Government 2002	Required that the CFO and the CEO certify that the verity of the financial statements and be personally responsible for them. It also requires that board members be financially literate, sets accounting and audit standards, rotation of auditors, financial penalties on CFO and CEO for incorrect/ inaccurate statements or non-compliance, restriction of insider trading, restriction of personal loans to management and principal stockholders, management assessment of internal controls.
Corporate and Criminal Fraud Accountability Act, (USA) 2002	Prescribes financial and criminal penalties for tampering of records, and securities frauds, impeding federal investigations, whistleblower protection
Final Coordinating Group on Auditing and Accounting Issues in the UK (CGAA) 2003 (UK) 2003	Recommended the formation of an independent group to develop the existing guidance on audit committees contained in the Combined Code and to clarify the roles of audit committees with the backing of the British Financial Reporting Council
Higgs Report 2003 (UK)	Independent review of the role and effectiveness of non-executive directors on a board of directors
“High level Group of Experts” Report European Corporate Governance Forum 2004	To enhance the convergence of national corporate governance codes
Company Responsibility Act 2004 (UK)	Directors duty of care for both society and environment
Company Law Reform Bill 2005 (UK)	Clarifies the role of directors, their responsibilities to employees and the impact of the companies activities on the environment.
FTSE4Good series of indexes (Financial Times and London Stock Exchange)	
Dow Jones Sustainability Index	

Adapted from Thomson and Jain (2006)

## Corporate Accountability: The Australian Perspective

Corporate and banking sector accountability in Australia is controlled by the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investment Commission (ASIC) amongst others (See Table 2 for an outline of the organisations that monitor corporations in Australia) (Acquaah-Gaisie, 2000). Australian Law that prescribes the codes for corporate accountability include the Crimes Act 1914, the Income Tax Assessment Act 1936, Trade Practices Act 1974, Proceeds of Crimes (Taxation Offences) Act 1980, Crimes Act 1987, Criminal Code Act 1995, and the Work Place Relations Act 1998, Corporations Act 2001, with the latest prudential standards relating to Governance being Prudential Standard APS 510 and APG 510 released in May 2006 for implementation in October 2006.

**Table 2: Organisations monitoring corporate accountability in Australia**

Organisation	Role
Australian Competition and Consumer Commission	Set up under the Trade Practices Act 1974, to ensure the promotion of competition and fair trading and provision for consumer protection
Australian Transaction Reports and Analysis Center	Set up under the Financial Transactions Act 1998, AUSTRAC monitors the movement of money within, in and out of Australia. Helps in the tracking of international crimes.
Australian Securities and Investments Commission	Set up under the Australian Securities and Investments Act 1989 to regulate companies, securities and futures markets, promotes market integrity, market efficiency, investor protection and transparency. Power increased by CLERP 2003, 2004: monitor auditor compliance, continuous disclosure,
Federal Bureau of Consumer Affairs	Provides product information to consumers, protects consumers from fraudulent market practices, ensures product safety
National Crime Authority	Collects and analyses data on criminal activities, investigates crime that may impact on national security
Australian Prudential Regulatory Authority	Prudential supervision of all financial institutions
Australian Stock Exchange Corporate Governance Council	10 corporate governance guidelines and principals

Source: Modified from Acquaah-Gaisie (2000, 2005)

Penalties for breaching these acts range from fines and sanctions to imprisonment. Financial penalties have increased to AUD1 million for breaches of continuous disclosure with the infringement notice itself serving fines of up to AUD100, 000. A punitive approach is useful after a crime has been committed or in cases where there is breach of corporate accountability. The federal government has taken a proactive role in the prevention of loss of corporate accountability by the incremental increase in corporate regulatory standards.

In an analysis of the major corporate collapses in the last two decades, Acquaah-Gaisie (2005) states that the major causes of corporate accountability failure have been due to the presence of

weak boards of directors, breach of director's duties, poor management practice, poor accounting and auditing standards and breach of auditing standards, investment bankers greed, bribery and corruption, ostentation and waste. Despite the various causes, one thing is clear: the board bears responsibility for the collapse of the company and all the decisions the company makes. The 2002 CPA Australia survey further substantiates the view that poor CEO and board performance is responsible for corporate failure. The survey respondents were found to have very low confidence in corporate financial reporting, with 73% responding that they believed that company boards and the top two executives were to a great degree responsible for the corporate collapses in Australia, with less blame laid on external auditors, internal auditors and the rest of management.

The recent corporate crisis has been viewed as a generalized loss of control over organizational behaviour with the Australian Office of Bankruptcy (AOB) Annual Reports confirming that over half of all corporate collapses could have been averted with good corporate governance. The AOB attributes the common causes of corporate failure to bad luck (1%), internal factors triggered by external factors (15%), and approximately 50% from internally generated problems that could have been controlled by managers (McRobert and Hoffman, 1997). These explanations of corporate failure confirm the conventional views regarding the *causes* of failure, but could be just as easily seen as the *symptoms* of failure.

The key management danger areas are high gearing, tolerating loss-making divisions for too long, concealment of bad debts, management defects etc can be all traced back to lack of board oversight. NAB oversights were not atypical – HIH, World Com, Enron – in all cases directors have failed to respond to danger signals. The common thread in many of the sensational corporate collapses from the 1980s onwards has been the focus on the individuals, not the processes, for example, the Bond and Skase persona of the 1980s, the Williams and Adler of HIH, Rich and Keeling of One.Tel. This focus over-rode any insight into the social, economic and regulatory circumstances facilitating unexpected failures. The failure to take note of the generic factors that are present in all these corporate collapses has meant that individual events and circumstances are focused on to the detriment of determining the implications for future events (Dean and Clarke, 2001).

The major corporate scandals that have occurred since the 1990s, include such notables as the State Bank of Victoria, State Bank of South Australia, Pyramid Building Society, Ansett, HIH, Harris Scarfe, One.Tel, with the latest in 2006, being the Westpoint property trust in Australia. Globally, the international collapses of Enron, WorldCom, Arthur Anderson and Parmalat, have further eroded shareholder confidence in big business. The major banks, whilst not suffering a corporate collapse have not been without significant losses over this period, with Westpac

experiencing the largest percentage losses of GDP at 4.49% followed by ANZ with 3.37% both in 1993. NAB has recorded the next largest loss of the majors with a 2.11% loss in 2001 (See Table 3 Company losses). This has resulted in increasing scrutiny of the corporate governance standards and reporting by amendments to legislation worldwide, the first of which was the Sarbanes-Oxley Act of 2002. The Australian federal government reacted by accelerating the introduction of the CLERP 9 (Corporate Law Economic Reform Program), which would otherwise have remained in the pipeline longer.

**Table 3 Company Losses in nominal and percentage of losses to GDP (as Dec each year)**

<b>Year</b>	<b>Company</b>	<b>Loss nominal \$m)*</b>	<b>Nominal GDP (\$m)</b>	<b>Losses (% of GDP)</b>
1963	Reid Murray	47	51,014	0.09
1990	Adsteam	2,100	132,562	1.58
1990	Bond	5,330	132,562	4.02
1990	Quintex	1,260	132,562	0.95
1990	Hooker	1,960	132,562	1.48
1990	SBV	2,700	132,562	2.04
1991	SBSA	3,150	131,584	2.40
1993	CBA	2,976	141,806	2.10
1993	Westpac	6,367	141,806	4.49
1993	ANZ	4,690	141,806	3.31
2001	One Tel	650	194,133	0.33
2001	HIH	5,300	194,133	2.73
2001	NAB	4,100	194,133	2.11
2004	NAB	804	213,499	0.38
2006	Westpoint	1000 (est)	219,285	0.46

Sources: GDP data taken from RBA Bulletin Statistics, Table G10

\* Loss data to 2001 taken from CCH Australia Ltd (2001) Collapse Incorporated

In the wider community, large-scale corporate collapse have had devastating consequences: loss of jobs, increased bankruptcies, loss of wealth particularly for small investors, reduction of superannuation funds, multiplier effect on other industries/ firms directly or indirectly linked to the mega-firm in trouble, reduction of share price, increased government bail outs, and loss of faith in the corporate world and stock markets. This prompted the formation of an Accountability Rating (CSR Network 2004) to assess the role of big business in society, their sustainability and long-term economic value.

### **Board Function: Evolution in Fast Forward**

There have been a number of studies that have examined the relationship between corporate governance and more specifically board function and performance. Studies by Collett and Hrasky

(2005), Chiang (2005) and Doucouliagos and Hoque (2005) find a positive relationship between share price performance and firm performance, whilst Heracleous (2001), Korac-Kakabadse et al (2001) and Kiel and Nicholson (2004) don't necessarily find a relationship.<sup>2</sup> The evidence is not clear-cut but intuitively there would appear to be a positive correlation between good corporate governance practice and corporate performance. A good working relationship between the board of directors, management and other stakeholders in a given firm would result in increased efficiency, throughput and profits with resultant higher stock prices.

By contrast, Sonnenfeld (2004) dismisses as myths the many studies that attempt to measure good governance by suggesting a relationship between board structure and performance, board structure and equity, and the independent board. A case in point being for companies that experienced governance crises, such as Enron, the NYSE, and HIH, all met the measures that are standard for assessing board function, such as director attendance (nearly perfect in Enron's and HIH's case), board size, number of other boards the directors sit on and number of independent directors. These are outmoded standards according to Sonnenfeld, and the real question of how to assess and improve governance performance is yet to be answered. The question of how to measure the *human side* of governance procedures is still the challenge. Legal and accounting mandates such as the APG510 and the *ASX Principles of Good Governance* address only part of the challenge. At least as important are the human dynamics of boards, where leadership ability, decision-making processes, conflict management, transparency, inclusion of agents in the decision making and monitoring process and the like, truly differentiate a firm's governance.

Nicholson and Kiel (2004) described the functioning of a board as multidimensional and its decision-making influenced by multiple factors. They formulated a diagnostic framework to analyse where and how boards are going wrong. The key inputs to the board performance relationship are organisation type, the company's legislative and societal framework, the organisation's constitution and lastly, company history, which reflects the broader influences of past events. The key past events that impact current corporate governance expectations are past performance, corporate culture, values and decisions on board composition that will affect how the board functions. Further they found that no single theory: stewardship, agency nor resource dependence theory can offer a complete explanation of corporate governance – corporate performance relationship.

The scope of Board role and functions now extends beyond its fiduciary and regulatory function to include compliance with the law of the land. The board is now ultimately responsible for all decisions and actions of the corporation (APRA 2006a and b). Section 16 of the APG510 requires

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<sup>2</sup> See Thomson and Jain (2006) for a more detailed review of corporate governance studies.

that a Boards must have a majority of independent directors at all times, the chairman must be an independent director and cannot have been the CEO in the previous three years. Clear requirements are made for independent directors and independence must comply with the ASX Corporate Governance Council's *Principles of Good Governance and Best Practice Recommendations*. The board needs to have a charter of roles and responsibilities which may include delegation of authority, ensuring the requisite skills of management and board members, fulfil residency requirements for companies registered in Australia, must be available to meet APRA, on request, must provide external auditor with the opportunity to raise matters directly with the board, ensure a composition that complies with legislation, ensure representation consistent with shareholding, appoint a Board Audit committee, review audit plans, ensure auditor independence, evaluate risk and have effective risk management plans and committees in place, establish performance assessment indicators for itself and have formal board replacement policies (APRA 2006 a and b).

Board dysfunction is responsible for major corporate collapses, non-compliance with the law and is caused by a desire by board members not to rock the boat (Westphal and Khanna, 2003). Board directors who have brought about change, which resulted in increased board independence, firing a CEO for poor performance, separating the role of CEO from Chairman found themselves ostracised at board meetings by the other board members. According to Westphal and Khanna (2003) the phenomenon of 'corporate cold shoulder' helps create a dysfunctional board, as was the experience of NAB in 2004 following Cathy Walter's accusations that PwC and NAB directors colluded to influence the outcome of the PwC report. The questioning of the probity of the Report led to fellow board members requesting Walters to resign. Her counter claim requiring the other seven non-executive directors to also step down led to the most public brawl ever seen in an Australian boardroom. The public labelling of Walters as a dissident will probably result in the most extreme form of 'cold shoulder' with doubts of whether Walters will get another job on an Australian board again (Gettler, 2004).

Matheson (2005) has listed the causes of board dysfunction which include: disconnected board members not committed to a clear direction, lack of understanding of the principles and the laws of corporate governance, lack of accountability, personal agendas, lack of team spirit, distrust, inability to accept alternate points of view, factions within the board, lack of effective communication, refusal to accept compromises, no contribution to common goal and unnecessary argument amongst others. Matheson has prescribed a formula for alleviating these ills which comprises of training boards, formalising a board role and function, code of conduct, regular annual evaluations by an independent authority, engaging skilled facilitators, increasing the moderating role of chairmen to make them similar to that of the speaker in parliament. Shen

(2005) points out that no amount of legislation in isolation will ensure adequate performance by board members. The things that matter are remuneration, stock options and ownership, to increase effectiveness of *both* executive and non-executive directors.

The role of the board in the running of a corporation continues to evolve with the passage of time and the change in the nature of major investors (Becht, Bolton and Roell, 2005). The major investors and therefore interested parties in businesses have evolved from families to large numbers of small investors, a few large private investors to finally large institutions. Institutional investors often have nominated board members. When they become aware of breaches of corporate governance, they often find it easier to sell out rather than challenge the management, leading on to a fall in share price. Becht *et al.* (2005) also comment on the fact that the board usually comprises of management appointed members who know the business and have a vested interest in not rocking the boat.

The duality of the board and management (Sharma, 2004) compromises the very function that the board is supposed to perform: that of being the watchdog for the shareholder. Irrespective of the ownership pattern of the corporation, independent boards have been shown to be associated with a lower incidence of fraud and improved corporate governance. However, the definition of 'independent' remains open to interpretation by governments and courts (Harvard Law Review, 2006). Whilst various models to ensure board independence including: disinterested member, objective monitors, unaffiliated professional; have been proposed, there is no single perfect working model (Van den Berghe and Baelden, 2005). The case study of the NAB that follows highlights another board failure due to duality, lack of transparency of operations, lack of oversight function of the board, failure of the boards risk assessment and management functions.

The aim of an independent board would be to reduce agency costs (Harvard Law Review, 2006). This is because independence makes the board accountable to shareholders for performance. Independence is also the key to increasing informational transparency. To this end the APG510 (APRA, 2006a) policy document prescribes minimum standards for good corporate governance, which also include renewal, minimum expertise levels, diligence, prudence and oversight function levels. The parallel policy APS510 (APRA, 2006b) dictates that a company board in Australia necessarily needs to have an audit committee. This policy reiterates the CLERP 2004 policy of auditor independence and the restriction of auditors moving into client management roles and vice versa for a period of two years.

### **NAB's Experience, 2000-2006**

National Australia Bank Limited traces its history back to the establishment of the National Bank of Australasia in 1858, becoming a public limited company after incorporating on June 23<sup>rd</sup>, 1893. NAB is the largest financial institution (by market capitalisation and total assets) listed on the Australian Stock Exchange and is within the 30 most profitable financial service organizations in the world with total assets of more than AUD459 billion. Despite these illustrious beginnings, more recent times have seen NAB recognise and acknowledge that corporate governance failure – in the form of board dysfunction, poor supervision, poor adherence to risk management systems and failed internal governance procedures – led to the company's poor performance and its reputation being adversely impacted by compliance issues, insufficient accountability and the lack of a clear cultural framework (NAB Annual Report, 2004). There had been significant media exposure of the NAB losses incurred in the HomeSide debacle (losses of over AUD4.1 billion) in 2001 and the breach of the U.S. Securities Exchange Commission (SEC) requirement of auditor independence in 2004 (Oldfield and Cornell, 2004). The foreign exchange scandal arose when four traders took part in fictitious trades which allowed the currency options desk to falsely report a \$37 million profit in October 2003, when its real position was a \$5 million loss, which protected the performance bonuses of the traders but caused losses of AUD360 million to be recorded in 2004 (Thomson and Jain, 2006).<sup>3</sup> The foreign currency trader debacle has resulted in three of the traders being found guilty in a court of law, and the fourth pleading guilty to related offences (Murray, 2006). NAB is intending to pursue a compensation claim from global money brokers, ICAP and Cantor Fitzgerald, for their part in allegedly helping the traders hide their illegal trades and losses and for their failure in not alerting NAB management to mounting losses, allegedly hidden from management by false accounting by the now convicted traders.

### **Performance Measures: NAB Compared to the Major Banks (2004-2005)**

Despite being an extremely profitable bank, with in excess of \$2 billion in profits reported in 2005, when compared to the other four major banks over the period 2004-5, NAB has the lowest Operating Profit after Tax/ Average Total Assets, (0.79% in 2004 with some improvement to 0.99% in 2005 but still low when compared with the sector average of 1.13%). NAB ranked last with return on shareholder equity of 15%, significantly below the sector average of 18.5% in 2004

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<sup>3</sup> For a more detailed explanation of the NAB losses on HomeSide (AUD4.1 billion) with their naive venture into offshore mortgage markets; currency options issues caused by the traders positioning NAB's foreign currency option portfolio in expectation that the falls in the US dollar that occurred in mid-2003 would reverse and that volatility would stabilise see Thomson and Jain (2006). Rather than close out their positions as the market moved against them, the traders chose to conceal their true positions, allowing those positions to deteriorate before they were finally discovered and reported to management by junior employees (APRA, 2004). Frank Cicutto, the then CEO, stated that traders at the center of the scandal had exploited weaknesses in the bank's internal procedures to hide trading losses and protect bonuses.

(See Table 4), although the sector average was considered by KPMG to be below the industry benchmark of 20%. The average return on equity for the sector has reached 21.02%, as at 31 March 2006, to rise above the benchmark for the majors for the first time, with all the majors, except NAB, achieving it (KPMG, 2006).

**Table 4 Comparison of NAB performance with the Major Banks 2004-2005**

	Year	Operating Profit After Tax/ Average Total Assets %	Return on Shareholders equity %	Net Interest Income/ Average Total Assets %	Interest Margin %
<b>Australia and New Zealand Banking Group Limited (M)</b>	<b>2005</b>	<b>1.09</b>	<b>17.5</b>	<b>2.10</b>	<b>2.35</b>
	2004	1.24	17.8	2.31	2.49
<b>Commonwealth Bank of Australia (S)</b>	<b>2005</b>	<b>1.26</b>	<b>16.0</b>	<b>1.88</b>	<b>2.45</b>
	2004	0.90	12.7	1.89	2.53
<b>National Australia Bank Limited (M)</b>	<b>2005</b>	<b>0.99</b>	<b>15.0</b>	<b>1.70</b>	<b>2.20</b>
	2004	0.79	15.8	1.78	2.35
<b>Westpac Banking Corporation (S)</b>	<b>2005</b>	<b>1.12</b>	<b>21.4</b>	<b>2.08</b>	<b>2.50</b>
	2004	1.09	20.7	2.04	2.53
<b>St. George Bank Limited (S)</b>	<b>2005</b>	<b>1.21</b>	<b>22.6</b>	<b>2.31</b>	<b>2.59</b>
	2004	1.16	21.4	2.43	2.70
<b>TOTAL 2005</b>		<b>1.13</b>	<b>18.5</b>	<b>2.01</b>	<b>2.42</b>
<b>TOTAL 2004</b>		<b>1.04</b>	<b>17.7</b>	<b>2.09</b>	<b>2.52</b>

*Source: KPMG (2004, 2005) Financial Institutions Performance Surveys*

In terms of the ratio Net Interest Income/Average Total Assets NAB performed poorly when compared to its peers, decreasing by 0.08% over the year and having the lowest ratio at 1.70% compared to St. George, the smallest of the group, having the highest at 2.31% and the sector average of 2.01% (KPMG, 2005). The larger the Net Interest Margin, other things held constant, the greater will be the contribution to profitability. NAB's interest margin is the narrowest of all five banks at 2.2% compared to the average of 2.42% (See Table 4).

In terms of profitability, NAB was the only bank of the majors to encounter extremely large declines in both before-tax and after-tax operating profits (-15.8% and -19.7% respectively) in the year 2004 compared to the sector averages of 9.0% and 6.4%. In 2005, NAB, along with the CBA

experienced very strong growth with both these measures returning to the positive realm and significantly higher than the industry sector average with before-tax profit recorded at 37 % against the sector average of 27.2% and after-tax profit of 30.1%, compared to the average of 25.1% for 2005 (See Table 4).

The cost to income ratio (operating costs/operating revenue) has been of some concern to NAB, particularly when it jumped to 57.4% in the March 2004 half-year report, up from 50.8% at the same time in 2003 (See Table 5). The ratio is sharply higher than any of its four main rivals, ANZ reported a cost to income ratio of 52.7%, Westpac's fell to 48%, whilst St George bank boasts the lowest cost to income ratio of just 45% compared with the sector average at 49.2% (KPMG 2004). Over the past three years NAB might be the biggest bank, but by no means is it the best, lagging the other four majors in most key financial measurements as the smaller the values of these cost efficiency ratios the greater the efficiency (Hogan et al, 2004). A measure of growth is the increase in total assets. Whilst all banks experienced positive growth in total assets, once again NAB has the lowest growth of the five, with 2% increase in total assets in 2005, less than a third of the sector average of 6.8%, and in 2004 at 3.5% only one quarter of the major's average of 13.1%.

Share price and total shareholder return (TSR) are two further measures of performance, with the former being easily observable and reflecting the market and shareholders' views directly whilst TSR (expressed as a percentage) can be easily compared from company to company, and benchmarked against industry or market returns, without a bias regarding size. The Global Investor Opinion Survey on Corporate Governance found that 73-78% of investors would be willing to pay a higher share price and that 57% would change their holdings for a well governed company (McKinsey and Company (2002).

The announcement of the HomeSide loan debacle in July 2001 led to a sudden fall of 5.5% in the NAB share price on the NYSE (Collections World, 2001). The impact was more dramatic and significant on the ASX with NAB's ordinary share price falling 33% from a high of AUD35.13 in July to a low of AUD23.80 by September 2001. The announcement of the foreign currency scandals, followed by the very public board ructions, caused NAB share price to fall 19% from a high of AUD32.12 in January 2004 to AUD26.04 by September 2004, with partial recovery in the share price occurring slowly over many months (see Table 5 and Figure 1).<sup>4</sup>

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<sup>4</sup> The share data in Figure 1 doesn't capture the full extent of the share price drop in 2001 as the data is year-end share price.

**Table 5 Comparison of NAB performance with the Major Banks (cont) 2004-2005**

	Year	Cost to Income Ratio %	Increase in total assets %	Increase in Operating Profit Before Tax %	Increase in Operating Profit After Tax %	Share Price \$	Dividend Payment \$
<b>Australia and New Zealand Banking Group Limited (M)</b>	<b>2005</b>	<b>45.6</b>	<b>13.0</b>	<b>6.7</b>	<b>7.2</b>	<b>28.5</b>	<b>0.56</b>
	2004	45.3	32.6	21.7	19.9	20.82	0.51
<b>Commonwealth Bank of Australia (S)</b>	<b>2005</b>	<b>50.2</b>	<b>7.5</b>	<b>46.7</b>	<b>55.2</b>	<b>45.30</b>	<b>0.94</b>
	2004	59.2	15.4	29.1	27.8	39.95	0.85
<b>National Australia Bank Limited (M)</b>	<b>2005</b>	<b>57.7</b>	<b>2.0</b>	<b>37.9</b>	<b>30.1</b>	<b>37.70</b>	<b>0.83</b>
	2004	54.1	3.5	(15.8)	(19.7)	28.85	0.83
<b>Westpac Banking Corporation (S)</b>	<b>2005</b>	<b>46.6</b>	<b>6.0</b>	<b>18.8</b>	<b>11.0</b>	<b>30.84</b>	<b>0.56</b>
	2004	49.2	10.7	19.6	16.3	24.50	0.49
<b>St.George Bank Limited (S)</b>	<b>2005</b>	<b>45.5</b>	<b>10.9</b>	<b>14.5</b>	<b>16.2</b>	<b>23.82</b>	<b>0.74</b>
	2004	47.5	11.6	16.1	16.6	19.03	0.67
<b>TOTAL 2005</b>		<b>49.1</b>	<b>6.8</b>	<b>27.2</b>	<b>25.1</b>		
TOTAL 2004		51.1	13.1	9.0	6.4		

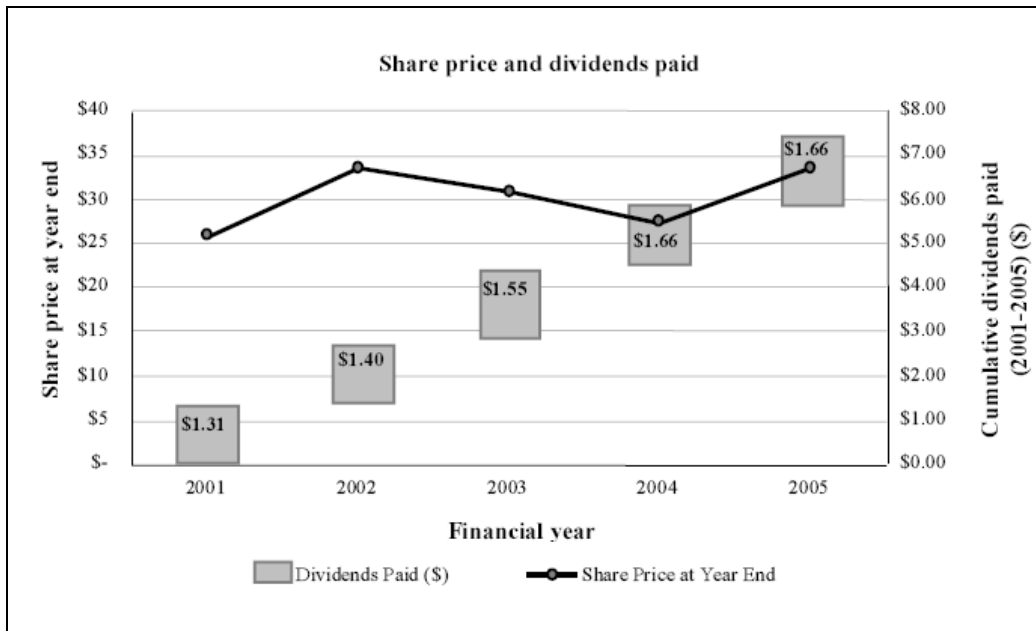
*Source: KPMG (2004, 2005) Financial Institutions Performance Surveys*

Further costs to NAB and its shareholders have been estimated at \$2 billion, the value of NAB's underperformance against the other major banks in 2004 and in the preceding 12 months. At the time NAB's earning per share was approximately \$2.50 a share, at a share price of \$30, the price/earnings was 12 times, whilst CBA and Westpac were selling at 15 times earnings. Two years previously, NAB had been earning at 15 times earnings and if re-rated the share price in 2004 should have been nearer \$37.50, instead of the \$28.85. This would be nearer to what CBA was trading at in 2004 (See Table 5) (Kohler, 2004).

The TSR performance represents the change in capital value of a listed company over a period (typically 1 year or longer), plus dividend, expressed as a plus or minus percentage of the opening

value. (Value Based Management, 2006).<sup>5</sup> Given the HomeSide losses of 2001 and the tumultuous board events that followed the currency trader losses in 2004 it was to be expected that there would be some fallout and evidence of market discipline on share price and hence on the more comprehensive TSR performance measure. The TSR provides a compelling picture; recorded at just 7% in 2001 but rebounding back to 38.6% in 2002. The year 2003 saw the TSR fall to -1.8% and fall even in further in 2004 to a low of -5.2%, lower than any of the opening values recorded between 2001 to 2005, but as the share price recovered over the latter half of 2004 the TSR rebounded once again to 32.3% (See Figure 2). The TSR is an important measure of performance for shareholders and investors providing information that shows the direction the share price is likely to take and the return to the investor, giving some indication of whether to invest in the share or not.

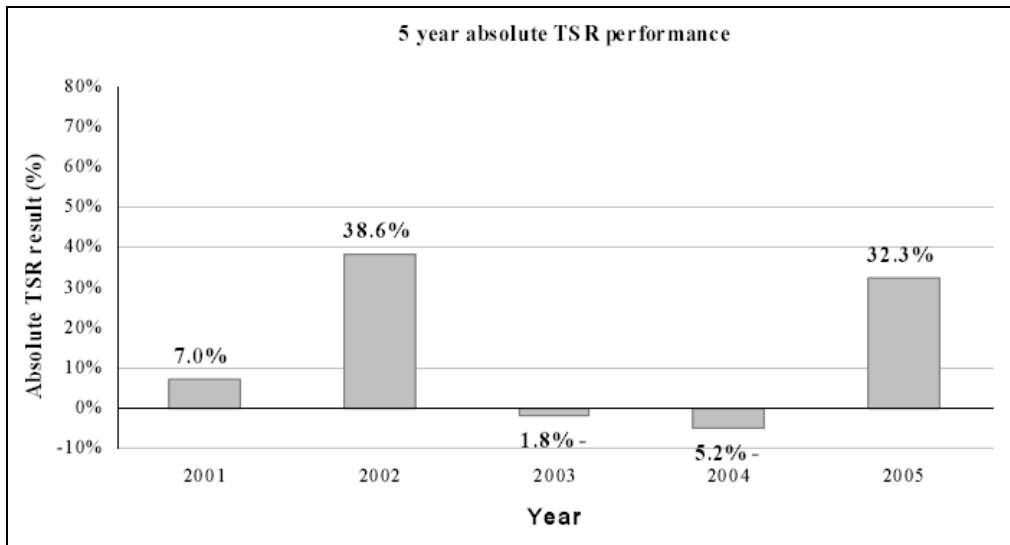
**Figure 1: NAB Year-End Share Price and Dividends Paid 2001-2005**



Source: National Australia Bank, Annual Reports, (2005)

<sup>5</sup> Calculation of Total Shareholder Return Formula (TSR) = (Share Price at the end of the period - Share Price at the beginning of the period + Dividends) / Share Price at the beginning of the period = Total Shareholder Return.

**Figure 2: NAB Total Shareholder Returns 2001-2005**



*Source: National Australia Bank, Annual Reports (2005)*

The comparison between NAB and its peers' data is sufficiently strong to draw some inferences regarding board governance issues and performance. In every measure - the measures of profitability, cost ratios and share price fluctuations that are shown in Table 4 and 5, and Figures 1 and 2, NAB has the lowest profitability measures and highest cost ratios of the five banks included in the major banks grouping. The picture provided supplies strong evidence for suggesting that the events that NAB suffered during the 2001-2004 years had a significant impact on their profitability, ROA, ROE, Cost-to-income ratio, TSR and share price.

### **Board Dysfunction: Cause and Consequences**

Good governance should involve commonsense assignment of roles, responsibilities and accountabilities within a corporation. It requires demarcation between the roles and responsibilities of board and management, and needs to ensure that the appropriate structures and processes are in place to meet the assigned responsibilities. NAB's failure was in its risk management systems and the then existing culture, which was described by the regulators, as an environment where the main concern was with profit, with other shortcomings being overlooked (APRA Report 2004).

APRA's review considered the NAB internal control (Internal Governance) frameworks satisfactory and that faults that occurred lay with the implementation to existing safeguards rather than the design of the safeguards themselves. Rather losses could be attributed to an operating

environment characterized by lax and unquestioning oversight by line management; poor adherence to risk management systems and controls; and weaknesses in internal governance procedures.

External oversight requires the auditors to perform routine checks and to ensure that the organization carries out their tasks using the correct procedures. In line with the ASX's requirements for the top 200 listed firms to have an internal audit committee, in 2003 NAB formed a new Board called the Principal Board Audit Committee (PBAC) to discuss and investigate any high risk issues that are raised by either the Internal Audit or the external auditors, KPMG. They also introduced a new Internal Audit rating system that would directly report to the PBAC. The chairman and then CEO were part of new Audit Committee with direct lines of accountability and responsibility to the Board (NAB Annual Report 2004). Despite the committee being held responsible for reviewing risk management practices, there were no meetings held during 2003 although warnings had been issued concerning risk management practices by both the external auditor as early as 2001 and APRA in mid-2002 following an on-site visit to the bank (Grant, 2005).

Once the \$360 million foreign currency losses became public in January 2004, NAB appointed PwC to investigate the irregular trading of foreign currency options and concurrently APRA undertook a review of the bank's practices. Almost immediately concerns regarding the independence of the PwC report were raised as PwC became the "external experts" asked by the NAB to audit the scandal. The independence of the PwC investigation was compromised as they already had a close and extensive relationship with the NAB board with business links between the bank and PwC likely to cause a number of potential conflicts of interest. NAB director, John Thorn, had been the PwC financial services auditor and a PwC senior partner. He left PwC in September 2003 to join the NAB board just two weeks later! In addition PwC earned fees of \$17 million in 2003 from NAB, nearly twice the fees earned by NAB's own auditor KPMG (Myer, 2005). Elevating this report to the status of an independent report left it open to criticism, and particularly when Board member, Cathy Walter began raising concerns about the independence and probity of the PwC investigation.

Two issues of concern arose for Walters: firstly, the inappropriateness of appointing Graham Kraehe, the board member presiding over the internal risk committee, which had failed in its basic requirement to manage NAB's risk practices, to the chairman's position after Charles Allen stepped down. Secondly, Walters questioned the appropriateness of this committee being charged with the responsibility to oversee an investigation into the breaches of risk policy, the very issues that they had failed to identify in the preceding months. Walters' concern was that there was the

potential to influence the contents of the report and because of the business relationship with NAB; essentially PwC would have been investigating their own work. Deloitte, Touche & Tohmatsu and the law firm, Blake Dawson, were brought in to oversee the probity issues and in fact found that there were no issues that PwC were required to answer.

Walter's allegations of flaws and lack of independence in the PwC investigation were rejected by the Board directors. A public boardroom split ensued, when due to a loss of confidence, they called for Cathy Walters to resign. Walters resisted the pressure to quit and faced with an Extraordinary AGM, she put forward a counter proposal for all seven non-executive directors to step down as their terms came to an end.<sup>6</sup> The NAB board at this stage had become entirely dysfunctional – unable to work together to give management a clear direction. The inexcusable losses that reflected appallingly on management and board directors should have been dealt with promptly. Instead the NAB board spent three months publicly flagellating themselves (McCann, 2004). To exacerbate matters, the new CEO, John Stewart, was drafted onto the Board Committee to manage the proposed Extraordinary General Meeting (EGM). This was further seen as a totally inappropriate role for management to be appointed sit in judgement of Board members; instead this should have been a totally independent committee.

Issues of transparency and accountability are what dogged NAB over dissident director Cathy Walters. Regardless of the veracity of Walter's allegations regarding the PwC report, the NAB Board failed to handle accountability by allowing Chairman Charles Allan and CEO Frank Cicutto to leave precipitously before the release of the PwC report. Whilst it removed these individuals from the public eye, it also left the Board with no one to take responsibility for the events that had occurred at NAB over the previous three years, and it seemed that the market wanted retribution for the earlier HomeSide losses, which had not been dealt with adequately by the board in 2001.

Costly consequences continued as a result of the NAB board and risk committee failure to address the risk issues noted by the regulators and other foreign exchange industry players in the twelve months prior. APRA required NAB to comply with and implement a series of 81 remedial actions with on-site supervision imposed until the actions were fully implemented. NAB's approval to use an internal model to determine market risk capital was withdrawn and the currency option desk closed to corporate business until all areas of concerns in the APRA Report were addressed. Risk management strategies that had to be implemented prior to NAB's foreign currency option desk re-opening, over a year later in May 2005, included increased monitoring of all market risk

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<sup>6</sup> The Board does not have the power to sack board members; it must of necessity call an Extraordinary Annual General Meeting, as only shareholders have the legal right to remove directors.

limits with mandatory “hard” limits and trigger or “soft limits” which included a defined response and raised NAB’s internal target total capital adequacy ratio to 10%, up from the Group’s previous internal capital ratios of 9-9.5% (APRA Report, 2004).<sup>7</sup> NAB dealt with the additional need for capital by planning to raise \$2 billion of subordinated debt and a \$1.2 billion underwriting for its dividend reinvestment plan in order to keep the \$0.83 cents semi-annually dividend payout unchanged whilst still meeting the new 10% capital requirements. Their plan to use an investment bank to underwrite the dividend reinvestment plan meant that investors should have been made aware of the fact that NAB was disguising an ordinary capital raising in the form of a dividend (Hughes, 2004).

To add further to NAB’s woes and the new CEOs problems, falling margins in its British operations, increased regulatory costs as it prepared for international accounting reforms meant that the bank needed new strategies, but with no effective leadership team to guide it (Bartholomeusz, 2004a). During the same period, April to May 2004, NAB competitors started to exploit the reputational damage being done to the number one bank in Australia by targeting NAB’s customers ranging from corporations, medium- to small-sized businesses as well as their retail customers/clients. NAB had to respond swiftly, at any cost as total assets were growing at only 2% (see Table 5) compared to the industry average of 6.8% and to ANZ who had been a star performer with an increase in total assets of 32% in 2004 and 13% in 2005. Some measures implemented immediately were the waiving of mortgage fees, raising interest rates on deposits and issuing new products in order to entice consumers, which further contributed to NAB’s ballooning cost to income ratio, and in turn affected their profit margins as they tried to keep up with their competitors.

### **Regulator and Board Accountability**

Board culture, the term used to describe underlying values, beliefs and norms of the board has the most significant influence on its function. It is implicit within the firm and governs “the way we do things around here”. It is not the number of the board members rather their skill base which seems to have a better outcome for the board. Monks (1998) believes that non-executive (“independent”) members of the board are pivotal for good corporate governance but is highly critical of the processes that lead us to believe that members of the board are “nominated”, “elected”, are “independent” and that shareholders “vote” for their choice of nominees. Monks view is that the legal terms are used contrary to their commonly accepted usage. That the members of the board are in fact appointed by the CEO and incumbents tend to dilute the board’s legitimacy generally, but most specifically in determining the CEO’s remuneration. Mike Mayo,

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<sup>7</sup> Australian Banks adhere to the international capital adequacy requirement of a minimum 8% risk-weighted capital.

a Prudential Financial banking analyst, described the board culture that had developed at NAB as ‘too big, too old, too male, too full of ex CEOs and too many insiders’ (Cornell, 2004). The review of NAB’s practices by APRA suggests that problems existed in the culture of the institution for some time. The environment was seen as lax, those responsible for overseeing risk management failed to either identify or follow up the limit breaches and other irregularities coming from the foreign exchange desk. Cornell (2004) stated that Stewart (CEO) was not just unwinding the past five years of mismanagement under Cicutto, but he is also unwinding the disasters from the preceding CEO. The lack of accountability by the management and the Board seems to have stemmed from at least the HomeSide incident if not before. Maiden’s (2004) view is that seeds were sown in 2001 when no director or board member took responsibility or the ‘fall’ for the AUD4.1 billion losses that occurred.

The Audit Committee failed to discover fraudulent practices in their internal review of NAB accounts but over the next couple of years the external auditor was to flag areas of concern that were rated minor, for example, KPMG listed in both their 2001 and 2002 Reports to the Audit Committee that there were some 50 items of possible weaknesses in need of attention. These were classified as minor, not representing a threat to the integrity of the accounts and as such they did not attract the attention of the PBAC. In 2003 KPMG signed off on the accounts, but now the concerns had been upgraded and were listed as major concerns. At the same time, an APRA report detailing issues of concern relating to risk management practices in currency dealing rooms was handed to the chairman in January 2003 (exactly one year before the foreign currency scandal broke) but failed to deliver any action (APRA, 2004). In light of the NAB experience, auditors and regulators are now unlikely to attach a major/minor issue to a report or allow a report to go un-actioned. Each concern will have to be dealt with by the audit committee before auditors will sign off and regulators will be looking for compliance by boards or imposition of generic, more expensive regulator models for risk management will be imposed.

Within two months of the foreign currency scandal becoming news the NAB board was in disarray. The bank lost a majority of their key personal consisting of their board chairman, CEO, chief financial officer, the head of its corporate and institutional banking division, head of markets, head of risk management and a string of other managers and staff (Bartholomeusz, 2004b). Whilst the loss of key staff contributed to part of the market judgment and mark-down of NAB share price over the months that followed, the public expunging of the board and top management positions may have been necessary to remove perceptions – real and imagined – relating to lack of accountability and the breaches of corporate governance internal controls. In Laker’s report to the Parliamentary Inquiry, May 2004, there is a strong indictment of the NAB Chairman, the head of risk management and the CEO.

The view from Laker was that the Report received 'a fair degree of resistance' and was not passed on to the board. The Bank took no heed of this warning although it gave a commitment to APRA to meet a timetable for remedial risk management action based on an August 2003 on-site meeting with regulators, but again, the Chairman or the Board took no action. By not passing on the APRA letter, Allen let an operational and compliance void be exploited by the traders while their superiors did nothing. This is a classic case of the problem of double/ multiple agency endemic in every organization, and in human nature (Child and Rodrigues, 2003). Further even if the report had been tabled, one wonders if board members would have acted on it for fear of rocking the boat and/or fear of being ostracized.

How accountable was APRA as the banking industry's key financial regulator? There would seem to be a need for increased and more effective monitoring by the regulator and the question should be asked whether APRA played a proactive enough role. There was considerable laxness in APRA's oversight of NAB with failure to act promptly to warning signals (NAB 2004 Annual Report). APRA's reliance on the PwC investigation into the foreign currency losses also seems inappropriate. To avoid potential conflicts of interest the regulator needs to have sufficient resources to run its own independent audit committee/ investigative committee rather than relying on one of the big four accounting firms to undertake the factual part of the review, as happened in the NAB review. Mandatory 'arm's length' investigation and more powers to be granted by legislation to the regulatory body may mitigate some of these concerns.

The 1997 Wallis Report established APRA as a light-handed regulator, but the collapse of HIH in 2001 led to strong criticism that the regulator had been 'asleep at the wheel'. The subsequent Royal Commission into the HIH \$5.3 billion collapse found that APRA had several deficiencies, including staffing shortfalls, outdated legislation and an inadequate supervisory methodology. Post-HIH these inadequacies have been addressed and APRA has been given greater investigatory responsibilities (Grant, 2005). Whilst APRA's response to NAB's trading losses and breaches of risk management guidelines was swift and severe in terms of the conditions imposed upon NAB in March 2004, the impact of its actions were blunted when it is realised that the regulator had concerns as early as 2003. Following on-site visits in 2003, APRA expressed these concerns to the NAB board and management but failed to follow-up. Warnings should have been issued that unless the foreign currency irregularities were investigated and cleared to both the internal and external auditors satisfaction that closure of the foreign trading desk would occur. The lack of proactive behaviour by APRA in the NAB instance was similar to what occurred in regard to the HIH case. It appeared that APRA's own simulation of HIH data on proposed new capital standards found that HIH would have failed those capital requirements as far back as 1995. There was no consideration of bringing that information to the APRA board level and calling HIH to

account. The APRA Chairman, Jeffery Carmichael, when asked, agreed that it was something that APRA should have done! (Jay, 2001).

## **Conclusion**

The interaction of many groups of people is required for the creation of value in the commercial and investment and banking sector. There is a high risk of lack of transparency in many sectors and products, as there is the management of multiple risks, which are difficult to quantify and change with market movement and time (Perro, 1997). To this end, banks need to identify the firm's key value and risk drivers, assign clear lines of accountability for each driver and reinforce accountability.

The failure of NAB to ensure transparent systems of control and ensure accountability of divisions within the organisation by ongoing mutual monitoring led to significant falls in profitability, loss of shareholder value and climbing cost ratios. The comparison of NAB's performance with the other majors in 2004-2005 tells a compelling story. In the measures of profitability and cost efficiency examined, NAB had the lowest ROE, ROA and net interest income/average assets and the highest cost to income ratio of any of the five largest banks. The significance of the poor profitability outcomes and the increase in costs for NAB is that it was below the sector average in each case. The view of market commentators and John Stewart, the new CEO, was that in 2004 the bank had hit 'the bottom' and after stabilising, can begin recovery (Cornell, 2004).

The failure of accountability and board function at NAB highlights that good intentions are not sufficient to protect the interests of the principal in a firm. The board needs to be proactive, spend significantly increased amount of time and acquire expertise that is necessary for the performance of its duties, in line with the latest recommendations from APRA. Whilst the market will punish the firm by reducing the value of its stock once it is made aware of board lack of accountability and board failure, the shareholder is the ultimate loser. It remains in the shareholders interest to continue to monitor both board and management function. Conversely, good corporate management and accountability practices result in a win-win situation for the board and management whose bonuses and remuneration is tied to the share price and carefully monitored key performance indicators.

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