

OPERATIONAL RISK AND OPERATIONAL RISK RELATED BANKING SCANDALS/ LARGE INCIDENTS

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ÖZET

Bu çalışma operasyonel risk, operasyonel riskin tarihçesi ve gelişimi nedir tanımlamış, bankacılık sektörünün önemli operasyonel risk kaynaklı olaylarını ele almış ve Barings Bankası skandalının detaylı analizini yaparak kök sebepleri ve sonuçları ile Türk Bankacılık sektörünün risk yönetimine bakışını incelemiştir. Yapılan inceleme ve araştırmalara dayanarak öne çıkan operasyonel risk kaynaklı bankacılık skandalları incelenmiş ve Barings Bankası olayı: kök sebep analizi-çıkarılan dersler-iç kontrol eksiklikleri göz önünde bulundurularak analiz edilmiştir.

Anahtar Kelimeler: operasyonel risk, bankacılık skandalları, çıkarılan dersler, iç kontrol eksiklikleri, Barings Bank

ABSTRACT

This work has defined operational risk, history of operational risk and the most significant operational risk related banking scandals. Barings Bank scandal is investigated in detail by analysing the root causes & results and operational risk aspects of Turkish Banks. Based on the executed investigations and researches prominent operational risk related incidents are ex-

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amined and Barings Bank incident is analysed by considering the root cause analysis-lessons learned-internal control deficiencies.

Key Words: operational risk, banking scandals, lessons learned, internal control deficiencies, Barings Bank

1. Introduction

The term "operational risk" became prominent for recent years. On the other hand, operational risk is the oldest risk that Banks and/or other financial institutions face with. The importance of the subject has been started to increase results of the improvements in banking sector, events/crisis with high financial impacts derived from operational risk.

After implementing open market economy in Turkey, significant and rapid changes in financial markets occurred. Furthermore, occurred improvements and motive of improvements and change in banking sector did not bring only the profit also bring together the risks for the banks (AKGÜN, 2007). As well as, the number of banks and private sector companies have increased constantly since 1980s.

The banks also modified their control, risk measure models regarding these improvements and conversions. Regulators and related foundations introduced new regulations and adjustments. One of these reform is operational risk regulatory capital. Operational risk regulatory capital is started to be calculated since 2007. In Turkey, Banking Regulation and Supervision Agency (BDDK) conducts the regulations and rules for banks. Since the operational risk concept is very new for Turkish banks and the market, there is a limited number of sources, analysis and guideline in Turkey and also in the other countries in terms of operational risk concept. Thus, there is also a potential growth regarding the risk field in banking sector.

2. Operational Risk

2.1. Description & History of operational risk

In general terms; operational risk is defined as all the risks which are excluded from the credit and market risk.

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 excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements¹.

However, the Basel Committee recognizes that operational risk is a term that has a variety of meanings and therefore, for internal purposes, banks are permitted to adopt their own definitions of operational risk, provided that the minimum elements in the Committee's definition are included.

Operational risk is the oldest type of risk faced by banks. Moreover, operational risk continuously evolves and occurs in different types. In recent years, the importance of operational risk for banks has been increasing due to the products and methods which are especially used in international financial markets and the technology in a very complex level. Technological progresses in the last 25 years, played an important role in the development of financial markets and financial engineering. This caused especially the formation of derivative products and other financial innovations. Thus, banks' risk profile assessment and actively management of its risks (for example, hedging and financial risk protection and asset-liability management) capability has improved and the risk management process (risk identification, measurement, monitoring and control) has become complex and versatile. In parallel with these developments, financial institutions dependence on key personnel and technological systems became very important (Boyacıoğlu, 1999).

¹ BCBS: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version. June 2004. P. 144

In line with these improvements auditors' interest has increased for operational risk and operational risk management started to be regarded as a separate discipline like credit and market risks. Another important reason for this development in recent years, many large-scale damage has exposed by the bank's caused by operational risk. For eg. Societe Generale (2008), Barings (1995), Daiwa (1995).

3. Examples of the most significant operational risk related banking scandals / large incidents

3.1 Bank of Credit and Commerce International (BCCI)

The bank was founded in 1972 in Abu Dhabi. Abu Dhabi is the wealthiest place of the United Arab Emirates. It is rich for oil and has borders on Saudi Arabia and Oman. The bank was incorporated in Luxembourg and headquartered in London with more than 400 branches and had subsidiaries throughout the world. It was primarily owned by Arabs from gulf countries and was essentially run in Pakistan. In 1975, it divided into two entities, the other established in the Cayman Islands which became known as "a bank within a bank" where billions of dollars could vanish without a trace.

This scandal is the story of how the wealthy and corrupt in Latin America managed to steal virtually every dollar lent to their countries by Western banks, creating the debt crisis of the 1980s. And also how the leaders of states such as Ferdinand Marcos, Saddam Hussein, Manuel Noriega, and others skimmed billions from their national treasuries and hid them in Swiss and Caymanian accounts forever free from snooping regulators; how Pakistan and Iraq got materials for nuclear weaponry and how Libya built poison-gas plants. (De Graw David, 2004)

3.2 İmar Bank Scandal

The collapse of İmar Bank as such was not a major surprise to close watchers of the Turkish Banking Systems but the financial results and the way it took place was shocking.

The loan portfolio, characterised by an exceptional connected-lending practice, consisted mainly of (direct and indirect) loans to companies owned by the Uzan Group. Once the BDDK was established (before BDDK was established, it had been monitored by Treasury), the new authority requested that İmar Bank shareholders re-capitalise the bank and reduce exposure to the Uzan Group. Because no action was taken, BDDK appointed a board member with veto powers in July 2001 and another representative was appointed to the board in December 2001. In 2002, during the May recap programme, the bank reduced its risk to Uzan Group companies; shareholders injected capital into İmar bank and BDDK decided to withdraw the board member with veto powers in August 2002. With a BDDK representative still on the board, the problem seemed resolved and a takeover was avoided.

The bank was hit again in June 2003 when the charters of the two regional power companies, which provided the bulk of the cash flow of the Uzan companies, were revoked by the Electricity Regulatory Board. This news led to a run on the bank and liquidity problems resulted. The board members of İmar Bank refused to cooperate with BDDK and resigned their posts in late June. Meanwhile, BDDK had only four board members and could not take a decision because a decision required at least five members. Upon the appointment by the government of the fifth member, BDDK cancelled the deposit-taking license of İmar Bank and declared that all personal deposits were under government guarantee.

Finally, the biggest problem emerged during the reconciliation carried out by BDDK to finalise the amounts due to depositors. The most recent reports of İmar Bank to BDDK, on June 2003, had showed a total deposit amount of TL 750 trillion (around \$0.5 billion). The investigation of depositors'

documents, however, revealed that this amount was actually TL 8.1 quadrillion (more than \$5 billion). The bank had also converted some offshore deposits (not covered by government guarantee) and sold Treasury bills to the public even though it did not have a license to do so. The bank maintained a double-accounting system throughout, where true information would exist at the branch level but the headquarters would falsify it and then report to BDDK (Steinherr A., Tukul A., Ucer M. 2004).

Moreover, in some sources Imar Bank scandal is not accepted as an operational risk event, arguing that the event was an organized crime. Another fact that this event had also damaged the banking sector and the system.

3.3 Soceite Generale / Jerome Kervie

Significant deficiencies in internal controls, unauthorized trading activities, computer hacking and the breach of trust involving a conscious effort by the rogue trader to deceive his managers were noticed. Jérôme Kerviel is accused of creating a huge loses by a single unauthorized trader in financial history. In the course of 2007 he made unauthorized trade worth € 30 bn. on European stock market futures, winning € 1.4 billion by the end of the year. Having disguised the importance of his exposure, and earnings, with fictitious trades, he went on in January 2008 to make even bigger trades. The bank stated that he deliberately set out to lose money in 2008 to bring down the suspicious size of his 2007 earnings. (Blanch, 2009)

It was the scandal that rocked the banking world. French Bank Societe Generale recently revealed details of a disaster created by a rogue insider who cost the institution \$7.2 billion in fraudulent trades. It was the biggest such scandal in history at that date
http://en.wikipedia.org/wiki/January_2008_SocieteGenerale_trading_loss_incident.

3.4 Barings Bank / Nick Leeson

(1762 to 1995) was the oldest merchant bank in London until its collapse in 1995 after one of the bank's employees, Nick Leeson, lost £827 million (\$1.3 billion) due to speculative investing, primarily in futures contracts, at the bank's Singapore office (http://en.wikipedia.org/wiki/Barings_Bank 2011). This incidents will be given in detail on following pages.

3.5 Daiwa Bank / Toshihide Iguchi

One of its employees had been illegally trading U.S. Treasury bonds for over eleven years without detection, causing the bank an accumulated loss of \$ 1.1 billion. Since then, this incident has turned into an international scandal, resulting in civil, criminal, and administrative liabilities in both the United States and Japan. There has never been an economic incident with such a big international impact between Japan and the United States.(The Vanderbilt University Journal1996)

3.6 Allied Irish Bank / John Rusnak

The Allied Irish Bank (AIB), the second largest bank in Ireland, was rocked by one of the largest scandals in banking history in 2002, losing over \$691 million when a currency trader (John Rusnak) in their Baltimore office invested unsuccessfully in Japanese yen and kept the bank's losses a secret for nearly five years. (<http://www.scribd.com/doc/39948847/Encyclopedy-white-collar-crime> 2011)

3.7 Bomb Attack on HSBC Bank Headquarter (Istanbul)

On November 15, 2003, two trucks carrying bombs slammed into the Bet Israel and Neve Shalom synagogues in Istanbul, Turkey and exploded. The explosions devastated the synagogues and killed twenty-seven people and injured more than 300 others. Five days later, on November 20, as US Presi-

dent George W. Bush was in the United Kingdom meeting with Prime Minister Tony Blair, two more truck bombs exploded. Suicide bombers detonated the vehicles at the headquarters of HSBC Bank AS and the British Consulate, killing thirty people and wounding 400 others. The bombers appeared to have waited for the traffic lights in front of the HSBC headquarters to turn red to maximize the effects. The bombers have timed the attacks to coincide with Bush's visit to the UK (http://en.wikipedia.org/wiki/2003_Istanbul_bombings 2011). HSBC's country of origin is England and was the target of the terrorists. Since the bank has sufficient back-up systems, continuity of its operations could be ensured very quickly.

3.8 Earthquake on 17 august 1999 and banking losses

On August 17, 1999 a magnitude MW 7.4 earthquake struck the Kocaeli and Sakarya provinces in northwestern Turkey, a densely populated region in the industrial heartland of Turkey. The August 17 earthquake is considered to be the largest event to have devastated a modern, industrialized area since the 1923 Tokyo earthquake. The tragedy created a big loss and damage on bank branches (Erdik M.1999). The banking transactions broke out and recovery of these losses took a long time and a big amount of money was spent for recoveries.

4. Case Study of Barings Bank

4.1. Overview

Barings Bank had a long history of success (had a history of 223 years before this failure) and was much respected as the UK's oldest merchant bank. But in February of 1995, this highly regarded bank, with \$900 million in capital, was bankrupted by \$1 billion of unauthorised trading losses.

In 1993, Nick Leeson was appointed as general manager of the bank's Barings Futures subsidiary in Singapore. In this ca-

capacity, he was able to conceal his unauthorised trading activities for over a year because he managed both the trading and back office functions. The senior managers at Barings came primarily from a merchant banking background and knew very little about trading. Even in the face of large profits, which should have tipped management off to the fact that substantial risks were being taken, they continued to believe that Leeson held matched positions on the Singapore International Monetary Exchange (Simex) and the Osaka exchange, and hence was making a low-risk profit.

In fact, Leeson was trading derivatives contracts on the two exchanges that were, in some cases, of different types and, in some cases, in mismatched amounts. For example, Leeson executed a trading strategy known as a "straddle," with the objective of making a profit by selling put and call options on the same underlying financial instrument, in this case, the Nikkei 225 Index. A straddle will generally produce positive earnings when markets are stable but can result in large losses if markets are volatile.

Leeson created an error account numbered "88888" as a holding area for any premiums or losses that he made. Leeson claims that he initially opened the account to conceal a single loss of 20,000 pounds sterling that had resulted from an accounting error until he could make up the difference through trading. However, he continued booking various losses into the account and also continued to increase his volume of trading and level of risk taking.

Leeson increased the size of his open positions even as his losses increased due to volatility in the markets. When an earthquake in Japan caused a steep drop in the Nikkei 225 equity index, however, Leeson's unauthorised trading positions suffered huge losses and his operation unravelled. On March 3, 1995, the Dutch bank ING purchased Barings for 1 pound sterling,

This incident can be seen as being caused by just one individual but in reality the fiasco should be attributed to the underlying structure of the firm, and particularly to the lack of internal checks and balances (<http://www.erisk.com/learning/casestudies/barings.asp> 2011)

4.2. Events in Chronological Order

1993: Nick Leeson becomes general manager of Barings Futures (Singapore), running the bank's Simex (Singapore International Monetary Exchange) activities.

January 1994: By this date (at the latest), Leeson started selling put and call options on the Nikkei 225 equity index, placing the premiums earned into an error account number 88888. This strategy, known as a straddle, is essentially a bet on the stability of market prices.

24 February 1994: A memorandum from the Barings' asset and liability committee values the options portfolio at 2.8 billion yen.

July 1994 - August 1994: James Baker, an internal auditor, spends two weeks in Singapore investigating the immense profits being made there. Baker identifies the weakness of internal controls and recommends that the general manager should no longer be responsible for the back office. In response, a separate financial manager in Hong Kong is given part-time responsibility for watching over the back office.

August 1994: In an attempt to better evaluate its overall risk, Barings sets up an integrated Group Treasury and Risk function, reporting to a new asset and liability committee (Alco).

December 1994: A later Barings investigation reveals that, for unknown reasons, Leeson has run up an accrued loss amounting to Y7.7 billion on the account by the end of 1994.

23 January 1995: The Nikkei 225 drops by 1000 points after an earthquake hits Japan's industrial heartland. Leeson be-

gins purchasing March and June 1995 futures contracts on the Nikkei.

26 January 1995: The London futures team gives Barings' Alco Committee a presentation on the Baring Futures (Singapore) operation, which states that Leeson is operating a perfectly matched book - long in Osaka, but short to the same amount on Simex.

8 February 1995: Coopers & Lybrand decides to hold off signing off on Barings' accounts until it becomes possible to clear up a few points with Leeson.

23 February 1995: At close of trading, the error account contains 55,399 Nikkei contracts expiring in March and 5640 expiring in June. As of February 25, this totalled a loss of 59 billion yen on Simex.

24 February 1995: The Barings Board meets to discuss a hastily-prepared analysis of the transactions in Account 88888 (<http://www.erisk.com/learning/casestudies/barings.asp> 2011).

03 March 1995: The Dutch Bank ING agrees to purchase Barings for 1 pound and assume all of its liabilities.

4.3 Internal Control Deficiencies at Barings Banks

The Barings collapse confirmed that internal controls at Barings were clearly insufficient to detect what was taking place with Leeson's derivatives trades. He lost so much money speculating in yen that he brought down the whole bank before the top management even knew what was happening. While initial accounts centered on the fraudulent activities of Leeson, and evidence suggests that Leeson was in fact engaged in highly speculative transactions and deliberately tried to deceive his superiors, his actions were not the only reason for the bank's failure.

Totally, inadequate internal communications, controls, and channels of accountability, insufficient regulatory oversight

and a lack of communication between regulators in the United Kingdom, Japan, and Singapore was revealed.

The most clear aspect of the lack of internal communication is that it was common knowledge on the futures markets that Barings was building an increasingly risky position. The failure of Barings' management to prevent the collapse of Barings also resulted from Barings' flawed internal controls and channels of accountability. Leeson was responsible for both the trading and the settlement sides of the Singapore operations. Thus, it made it easier for him to conceal his contracts from his superiors. Nevertheless, senior management officials at Barings had been made aware of this situation as early as 1992. At that time the head of Barings' Securities operations in Singapore alerted the firm's management in London to the potential dangers of having Leeson manage both trading and settlement. According to him, the fact that Leeson had no gross position limits on proprietary trading operations made the potentially dangerous management structure even worse.

From the evidences at that date, it seems that such concerns were not communicated to Barings' external auditors, who almost certainly would have included them in the annual report on management systems and controls, based on UK banking regulations. Senior executives at Barings conceded that they did not really understand the complex business of derivatives, so their guidance for Nick Leeson was not strategic in nature but was rather quantitative (Bhugaloo S. 2007).

4.4 Lessons Learned

It is important to understand what went wrong, what was done incorrectly and which controls broke down in order to provide an inclusive lessons learned.

In the wake of the rogue trader scandals discussed above, there were post-mortem analyses, reports by independent parties, findings by special committees, and even

Congressional hearings. In particular, following the disclosure of Rusnak's fraudulent conduct, Allied Irish Banks commissioned Eugene Ludwig, a former U.S. Comptroller of the Currency, to provide an independent report ("Ludwig Report") on what had gone wrong. More recently, losses in the financial markets stemming from the subprime market collapse have triggered their own series of reports and recommendations on risk management and supervision, most notably the President's Working Group on Financial Markets ("PWG") and the Senior Supervisors Group (which is an international group of financial regulators, including the SEC, Federal Reserve Bank of New York, and the Office of the Comptroller of the Currency).

Through these analyses, recommendations, and findings, several key risk management and supervisory control lessons emerge. (Wilmerhale 2008):

4.4.1 Setting the Right Tone from the Top

Senior management and BOD must encourage a culture of compliance and responsible risk taking. Collectively, Baring incident and the subsequent analyses of these kind of incidents underscore the importance of setting the right "tone from the top." In particular, senior management and boards of directors should emphasize integrity, and compliance concerns must be raised to independent functions within the firm and investigated and resolved – regardless of who is involved and how profitable the business unit appears to be. This policy should be communicated to all employees. In the case of Baring Bank, senior management ignored signs of potential wrongdoing and failed to establish long lasting controls or an environment of honesty and accountability. As a result, Nick Leeson was able to cover up losses and perpetuate fraud for years. In addition to emphasizing compliance and control, senior management and boards should play an active role in

encouraging responsible risk taking. Firms that were more successful in mitigating losses through year-end 2007 had senior managers who played an active role in (i) identifying and understanding material risks, (ii) acting on that understanding to mitigate excessive risks, and (iii) surmounting organizational structures that tended to delay, divert, or distort the flow of information up the management chain of the firm (Wilmerhale 2008).

4.4.2 Senior Managers Must Understand the Complexities of the Products Their Firms Trade

Perhaps the most obvious, but fundamental lesson is that proprietary trading is a high-risk activity, and not just for market risk reasons. The potential operational and market risks may outweigh the potential market returns, perhaps greatly. It is critical that supervisors understand their traders' strategies, the quantitative models, and mathematics of the products they trade – particularly before allocating more of the firm's capital to those traders. Trading management should discuss trading rationale and strategy on a regular basis with traders. Also, directors should be adequately knowledgeable about derivatives and risk management to appreciate the risks that might lead to material trading losses (Wilmerhale 2008).

4.4.3 Strong Business Line Supervisory Controls Are Crucial

Business supervisors are the main defense against any authorized, fraudulent, or excessively risky trading. In that regard, the Ludwig Report recommended a number of supervisory controls to help detect and prevent such trading, including: (i) daily review of trades by a registered and qualified supervisor (which include not only the summary of the profit and loss in each ledger, but also the actual trade tickets or a computerized summary of the information that would include all pertinent information on a trade ticket); (ii) reviews of exception re-

ports, which would show unusually large transactions, large profit and loss ("P&L") swings, unusual settlement terms, and major counterparty activity; and (iii) procedures for the creation, monitoring, and enforcement of position and trading limits (and intraday monitoring to ensure that traders stay within these guidelines).

The Ludwig Report also recommended that before each product is traded, the firm should document the market strategy, allocate credit, trading, clearing and settling procedures in advance, and then should monitor results against document strategy. Where there are exceptions, supervisors should not only inquire about the reasons for these exceptions, but also independently test the trader's explanation (Wilmerhale 2008).

4.4.4 Successful Traders May Require More Not Less, Scrutiny

Being interested in the results of huge profits instead of its reasons is an old story but very costly lesson. If a single employee/manager or a small group of employees executes a huge amount of profit to the company, this is a warning signal which must be examined in detail. In the Barings incident, the Bank of England investigation found that "management failed at various levels and in a variety of ways to institute a proper system of internal controls, to enforce accountability. ... to follow up on a number of warning signals over a prolonged period." This also proves that the collapse was not just because of a single trader, the top managers incompetencies, failures and ignoring what was going on also caused this collapse (Wilmerhale 2008).

4.4.5 Management Should Ensure that Incentive Systems Don't Encourage Excessive Risk

Incentive systems may be important in managing risks associated with proprietary trading. the Ludwig Report recom-

mended, among other things, that compensation arrangements with traders should be more in line with the market, and leave management with discretion so that factors other than trading performance can be taken into account when determining annual compensation.

More recently, the Institute of International Finance (a global association of banks) floated the idea of establishing a code of best practice that would (among other things) discourage banks from giving incentives to traders to take excessively risky bets. Others have suggested deferring bonuses until the full impact of a trader's strategy is clear, to prevent the trader from benefiting from short-term, high risk bets that may go bad (Wilmerhale 2008).

4.4.6 The Employees Must Go On Vacations Regularly

Management and supervisors should consider requiring traders to take mandatory vacations. According to media reports regarding SocGen, Kerviel neither took the mandatory holiday breaks, nor allowed other traders to monitor his portfolios when he did take time off. Indeed, he only took four days of vacation in 2007 – something that should have been a warning sign to his supervisors, according to Kerviel. As noted by one source, Kerviel attributed his ability to avoid detection to (among other things) his lack of vacations, and recently noted that “a trader who doesn't take vacation is a trader who doesn't want to leave his book to someone else.” Indeed, in a newsletter following the revelations of Kerviel's unauthorized trading, the U.K.'s Financial Services Authority recommended that firms require two-week holidays, which would allow other colleagues to inspect traders' books and ensure they were valued correctly (Wilmerhale 2008).

4.4.7 Risk Managers Should Be Encouraged to Challenge Traders' Valuations

Risk managers and other persons charged with verifying traders' positions should be encouraged to question those valuations when they appear idiosyncratic – regardless of whether or not the trader is successful. Some commentators recently have noted that an industry culture of deference by risk managers to successful traders may contribute to pricing failures and overly optimistic valuations on firms' books (Wilmerhale 2008).

4.4.8 Operations, Risk Management, and Compliance Reporting Lines Should Be Separate from the Business Lines

A key to a successful reporting structure is the complete segregation of duties from the front and back offices. One framework or organizational structure for overseeing trading activities should involve three distinct groups – the front office, the back office, and compliance.

In the case of Barings, Leeson managed the back office, so there was opportunity to manipulate settlement and other reports. A lack of segregation within his division allowed him to hide his losses from his superiors (Wilmerhale 2008).

4.4.9 Dual or Matrix Reporting Lines Must Be Clear

The relationship between parent companies and overseas units needs to be clear. If there are dual reporting lines or a matrix reporting structure, there must be unambiguous accountability, so that issues do not fall through the cracks and employees cannot exploit ambiguities in reporting structures. For example, with Barings, the Bank of England Report noted that no one appeared to carry out his or her responsibility to supervise Leeson in Baring's Singapore office, due in part to the absence of clear lines of authority (Wilmerhale 2008).

4.4.10 Strong Back-Office Controls Are as Essential as Front-Office Controls

By ensuring that proper back-office controls are in place, firms and their supervisors can greatly decrease the likelihood that unauthorized activity will continue undetected. In particular, the Ludwig Report recommended that back-office personnel should prepare daily reports and reports for periodic distribution to senior management, which should include (i) daily P&L movements, (ii) statistics relevant to indicate growing operational issues such as unconfirmed trades and unreconciled accounts, and (iii) counterparties' open transactions.

As an additional matter, it is critical that traders and other front-office personnel do not have access to systems that allow them to manipulate trading information, pricing data, and pricing models. The source of client and counterparty data should be independent from the front office and validated and input independently (Wilmerhale 2008).

4.4.11 Effective Risk Management is Critical

Risk management structure and practice that are flawed can quickly transform market risk exposures into significant economic losses for a firm. Because risk and risk taking are inherent in proprietary trading and it is easy to lose a great deal of money, commentators have emphasized that it is critical for proprietary trading operations to use the best information technology and systems available. Also, periodic reviews of these systems should be conducted and any deficiencies and reports of how deficiencies have been addressed should be presented to audit or other appropriate committees. More recently, the Senior Supervisors Group noted, in its analysis of risk management during recent market turmoil, that firms that tended to deal more successfully with the turmoil through year-end 2007 adopted a comprehensive view of their exposures. This means, among other things, using information developed across the firm to adjust business strategy, risk management

practices, and exposures promptly and proactively. In contrast, firms that experienced more significant unexpected losses at year-end 2007 allowed a more segregated approach to communications about risk management. Also, according to the PWG's Report (2007), the effectiveness of certain risk management practices was a key factor that differentiated institutions that sustained significant losses during the recent sub-prime financial crisis from institutions that avoided significant losses. In particular, firms that suffered significant losses tended to exhibit the following risk management weaknesses: (i) weak controls over potential balance sheet growth, including ineffective limits on the growth of business lines and poor monitoring of off-balance sheet exposures; (ii) inadequate communications among senior management, business lines, and risk management functions; (iii) dependence on a narrow range of risk measures that were based on assumptions that proved erroneous and on measurement processes that were difficult to alter once it became apparent that the underlying assumptions were wrong; and (iv) insufficient attention to valuation issues, including excessive reliance on credit ratings and inadequate development of models for valuing complex or potentially illiquid securities (Wilmerhale 2008).

5. Case Study Conclusion

Barings Bank is driven to bankruptcy by a single derivatives trader, Nicholas Leeson. Although the evidence to date suggests that Leeson was in fact involved in shady deals, it appears that other factors were also involved in the bank's collapse. Leeson's superior knew, or should have known, what the trader was up to, and had been provided with advance notice concerning his activities. Furthermore, Leeson was not the only trader engaged in such activities, and the philosophy of many financial institutions of the day appeared to encourage the sorts of techniques employed by Leeson. In the final analysis, the Leeson case demonstrates what can happen when one individual is entrusted with too much power, and only time will

tell if the remedial steps taken since then will preclude such recurrences in the future (Bhugaloo, 2007).

The firms should follow the related steps in order to mitigate their unauthorized activity events and internal fraud risks. These steps may include, to name a few:

- active management and boards who encourage a culture of compliance and responsible risk taking
- senior managers who are knowledgeable about the products their firms trade; effective risk management and front- and back-office controls
- independent and clear reporting lines
- incentive systems that do not encourage excessive risk taking. While it is true that, in the end, no system of controls will ever be foolproof, it is equally true that a culture of honesty and accountability, robust front- and back-office controls, and effective risk management systems will help (Wilmerhale, 2008).

6. Operational risk Approaches of Banks in Turkey & Conclusion

Effects of the financial crisis that occurred in the last 30 years has increased in the world. Especially the boost in liberalisation and deregulation, has provided new products to enter the market and has increased the integration of communication network and nations economy. All of these improvements have increased the risk. Thus, these factors add a new feature to the risk notion (<http://www.ilhanciftci.com/?p=7> 2011).

In Turkey, banks focus to control their potential losses regarding the market fluctuations (for ex.; endex fluctuations, changes in interest rates, and FX currency fluctuations). Corporates recognise operational risk when they exposed to a loss or when an authority mandates. Not accepting operational risks before the actualiation of operational risk is not a healthy

method. One of the reason of this kind of behavior is the responsibilities comes with the acceptance of risks. If there is a risk in a corporate and if it is not determined; in case of this risk's realisation it will be easier to explain not to take precautions initially to the legal authorities. On the other hand; if there is a risk in a corporate and if this risk is determined, corporates are expected to take mitigating actions and precautions in order to minimise this risk level and minimise the probability of occurrence (Türkoğlu, 2007). It would be impossible to explain not to take precautions about this risk.

Since taking precautions is a costly method, managers tend to neglect the risks. This is a major tendency between the executives. Even tough bank managers accept the presence of risks, they think it will not occur in their management period. So they do not reserve a serious sources on mitigating risks. Therefore, the managers tend to apply "save the day" politics. This perception began to change but still behind the required level and needs improvement (Çelenk H. & Okdemir Yılmaz 2011)

Required studies must be executed in order to ensure to make the approaches of banks to the operational risk more positive and efficient. Especially well cooperated university-finance collaboration should be implemented. Thus, solution for the implementation of the process in Turkey which is a problematic process can be executed more easily. Besides, it would help to establish a powerfull, trustable banking system (Yavuz, 2002)

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