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10TH EDITION



# MANAGING BUSINESS RISK

A PRACTICAL GUIDE TO  
PROTECTING YOUR BUSINESS

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# Corporate greed in the capitalist garden of good and evil

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## Introduction

With financial institutions as key sources and distributors of wealth within our societies, risk management departments are placed right in the middle of the debate as to what extent greed can be a force for good or a malevolent and destructive influence. We consider how the culture of an organization has an overriding effect on individual behaviours, some public examples of unacceptable behaviours, and to what extent the risk management department is empowered to manage the risks from excessive greed and what risk mitigants they may utilize. Finally, we consider whose responsibility it is to regulate an organization's culture.

Greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures, the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge, has marked the upward surge of mankind...

Michael Douglas as 'Gordon Gekko' in *Wall Street*, 1987

## **'Greed is alright, by the way. I think greed is healthy...'** (Ivan Boesky, 1986)

In the beginning, or rather, some time close to it in the second millennium BC, capitalism was created. And everything was fine; or at least for the most part, until the South Sea Bubble in the early 18th century. British investors in the South Sea Company and

the Mississippi Company lost much of their investments after the inflated value of the stocks crashed. The British government was forced to intervene in order to stabilize the banking industry. In fact, the British government outlawed the issuing of stock certificates, a law that was not repealed until 1825.

However, perhaps the relevant lesson for today's investors was the Wall Street Crash in 1929. This followed inflated stock prices, often manipulated by investment bankers, brokers, traders and even the owners themselves banding together to the detriment of unsophisticated or merely unsuspecting investors. By 1932, nearly 90 per cent of value had been wiped off the quoted stocks. In only the first quarter of 1933, over 4,000 banks had failed in the United States. The Great Depression followed, as did the establishment of the US Securities and Exchange Commission (SEC) to prevent further crashes and the fraudulent practices that had infected the stock market.

Then on 19th October 1987, the New York Stock Exchange fell 22.6 per cent in a single day following the exodus of investors amidst vastly inflated stock prices and a rash of insider trading investigations by the SEC. The Federal Reserve stepped in to prevent the insolvency of some commercial and investment banks.

Further market crashes ensued – for example, the 60 per cent-plus drop in the Nikkei through the 1990s and early 2000s, and the 'dotcom' crash during which the NASDAQ lost 78 per cent of its value (March 2000 to October 2002).

Regulators increased in numbers and increased regulation followed, but the markets had moved on, developed, become inter-connected and inter-reliant. Multiple regulators of multiple markets sprang up to regulate increasingly complex financial markets, where the views of various key rating agencies became critical to investors and the operation of certain instruments. This inter-relationship and connectivity of financial instruments paralleled the development of increasingly complex financial instruments since the 1980s, the advancement and use of technology to trade those instruments and the breeding of sedentary – or at least unsophisticated – regulators.

Just a few years later saw the credit crunch of 2007, the sub-prime crisis and global economic recession. Corporate failures, banking crises, government bail-outs, eurozone near-collapse, debt crisis, government bail-ins... politicians and media alike turned to the 'greedy' bankers to allocate blame while restructuring and empowering their regulatory bodies to hold them responsible and charging them to ensure it would never happen again. Just like in the 1720s, and the 1930s, and the 1980s, but with one fundamental difference: the scandals which accompany the crashes have moved from centuries apart to decades apart to years apart; maybe even to merely months apart.

In the midst of all of this sits the bank's risk management department, previously the habitat of corporate semi-grandees close to retirement and whose main role was to ensure delivery of a semi-annual board paper. Now these risk professionals are often qualified to a higher standard than the regulators whose multitude of rules they seek to interpret, while attempting to measure and mitigate the dozens of operational risks, before they strangle and destroy the very same organizations being blamed for the onset of the crisis.

In his 2011 paper 'Fear, greed, and financial crises: a cognitive neurosciences perspective',<sup>1</sup> Professor Andrew Lo comments on how periods of unchecked greed eventually lead to excessive leverage and unsustainable asset-price levels: 'It is not surprising that there have been 17 banking-related crises around the globe since 1974, the majority of which were preceded by periods of rising real estate and stock prices,

large capital inflows, and financial liberalization. Extended periods of prosperity act as an anaesthetic in the human brain, lulling investors, business leaders and policymakers into a state of complacency, a drug-induced stupor that causes us to take risks that we know we should avoid.'

If greed has driven the western civilized capitalism to its knees, how can it be a force for good in the corporate world?

## 'Culture eats strategy for breakfast' (Peter Drucker)

There is an assumption that a desire to make profit within an organization is a positive sentiment. That can of course vary depending upon the motives and ownership structure of an organization; however, even not-for-profit organizations still need to make money in order to fulfil their corporate objectives, for instance, the funding of good causes. The functionality of society implies that the creation of wealth is positive with social benefits accruing, such as the better health of the population, lower crime rates, increased living standards, and so forth. Conversely, the lack of wealth creation within society has negative effects on health, crime, etc. Of course, these are rather simplistic assumptions, taking no account of the methods of wealth distribution or the uses of wealth within society and their effects on social benefits.

When considering whether greed – let's call it the drive to make money – is 'good' within an organization, one should distinguish between an organizational culture of excessive greed (to the detriment of ethical standards) versus individual excessive greed leading to fraud and the wilful flouting of regulations. However, one person's ethics are not the same as another's, nor one organization's the same as another's; similarly, one society's ethics are not the same as another's, or indeed their politicians' and regulators'. The culture within an organization and the boundaries or behaviours acceptable within society vary according to the environment which we entrust to our politicians and regulators.

Our regulators, therefore, have the unenviable task of trying to distinguish between regulating the ethical practices of organizations and the behaviour of those working for them – the framework of compliance for the entity versus the entity's own framework for the staff it employs to satisfy its corporate goals, none more so than owner or shareholder demand for satisfactory returns on their investments.

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### CASE STUDY Corporate fraud

Much has been written about the corporate scandals of **Enron** and **WorldCom**, two organizations where it could be argued that unethical practices were embedded within the corporate cultures. The former grew to the seventh largest company in the United

States in just 15 years and precipitated the fall of Arthur Andersen, a giant of the accounting world. Both Enron and WorldCom were mired in accounting fraud and caused a raft of self-reflection amongst regulators and lawmakers. However, the problem didn't just go away amidst a flurry of litigation and legislation. The recent scandal at **Olympus** has highlighted that fraudulent practices can still become embedded within even the most high profile of companies.

Michael Woodford, former chief executive of Olympus, went public after discovering a US\$1.7 billion fraud. The board, having failed to end the cover-up, instead voted unanimously to fire him. However, possibly the biggest scandal of all has been the resultant lack of jail sentences for the former chairman Tsuyoshi Kikukawa, vice-president Hisashi Mori and audit officer Hideo Yamada; while the company was fined the equivalent of US\$4.6 billion and shareholders lost around US\$7 billion in value. The rationale given by the court was that, despite the executives all pleading guilty, they had inherited the frauds from previous managements and were not involved in the original decision-making. They didn't benefit personally from hiding the losses. The message seems clear: provided you don't originate the fraud or gain personally from it, the Japanese courts will accept that as mitigation for the organizational culture in which you operate. To many, that would appear to be a strange message and unlikely to benefit Japanese companies in the eyes of international business.

Such frauds can of course happen in any company in any country as illustrated by the three big European scandals in 2003: **Adecco** in Switzerland, **Ahold** in Netherlands and **Parmalat** in Italy.

Of course, one person's accounting fraud is another's misunderstanding. The last few years have seen a slew of US shareholder actions against Chinese companies who have filed prospectus documents offering shares in the United States. The litigation has been accompanied by adverse media, especially through the financial blogging sites in the United States. Unquestionably, there have been a few cases of misleading information and even outright fraud in order to lure potential investors. However, it is starting to become noticeable that the majority of the problems lie not in fraud, but in different accounting standards and the disclosures that accompany them. The debate switches to one of transparency of the differences between Chinese and US accounting rules, rather than one of wilful misdirection and misstatement. The courts, or the companies themselves, may determine that the investors in the offerings deserve some sort of recompense for any such alleged misrepresentation, but certainly US plaintiffs have not seen the size or number of settlements that they may have anticipated. Should we really be surprised that regulators from two completely different cultures on different sides of the world operate and regulate to different understandings of different accounting rules?

## The culture of employee fraud

Then there are those cases of outright fraud. In the insurance world, when a dishonest or fraudulent act by an employee of an organization leads to a direct financial loss for that organization, or a third party to whom it is held responsible, we term it 'employee infidelity'. Often the employee will perform such an act for their own personal benefit, but sometimes they will do it for someone else's enrichment – a good cause (eg a sick relative, a charity), a political or terrorist organization, or indeed organized crime.

There is a natural presumption that there is a synergy between risk and reward when considering the types of dishonest acts that are committed, but a look at most justice systems will tell you a different story. The potential rewards from a violent bank robbery pale into insignificance compared with the more 'white collar' frauds – electronic theft, for example – and yet the judicial repercussions are generally inverted. According to PricewaterhouseCoopers in their *2011 Global Economic Crime Survey*, cybercrime now ranks as one of the top four economic crimes and reputational damage resulting from cybercrime is the biggest fear for 40 per cent of the survey's respondents; the potential rewards are tremendous, possibly millions of dollars or even tens or hundreds of millions, yet the discouragements to commit such acts remain less than walking into a rural bank branch with a sawn-off shotgun where the potential take may only be a few thousand dollars.

Employee fraud remains one of the cornerstone operational risks determined by the Basel Banking Committee, as does external fraud. Banks are required to model their risk scenarios and to mitigate such risks through the setting aside of capital or, in limited instances, the purchase of qualifying insurance. Banking organizations will all profess to have excellent operational risk models, sound identification and modelling of risks, and appropriate measurement and mitigation of risks. They may all be correct, but the culture of each of those banking organizations is different, particularly in relation to what are acceptable levels of risk, dependent, potentially, upon the rewards available for individual risk taking within an organization. Do shareholders recognize that the organizations in which they invest have a higher or lower appetite for risk? Potentially, this is recognized through a perception of investment returns – they accept that a desire for returns significantly above industry norms will naturally come at an increased risk. However, it is highly doubtful that they would accept that achieving those returns comes at a compromise of ethical boundaries. There is and should be a reasonable expectation of the regulators to ensure that the environment in which companies operate allows reward of superior risk taking while stifling unethical behaviour within such organizations. It sounds simple, but history shows that regulators and legislators have to travel through an ethical and cultural jungle.

## The culture of the rogue trader

Various high profile cases of rogue trading provide good examples of the ambiguity between individual actions and the moral compass of the organization in which they operate.

## CASE STUDY Rogue traders

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In 1995, the British trader **Nick Leeson** singlehandedly brought down Barings Bank. Leeson was a star trader in Barings' Singapore branch, making huge profits in the early 90s speculating on futures derivatives. However, Leeson was hiding his losses in a secret account. He was discovered after the Kobe earthquake sent stocks plummeting, counter to his latest and largest bet which revealed the extent of his cover-up. The £827 million loss wiped out 233-year-old Barings' capital and reserves, and the bank collapsed.

In 1997, **Yasuo Hamanada** was sent to prison for eight years for unauthorized copper trades which ended up costing the Sumitomo Corporation US\$2.6 billion. For decades, Hamanada would have Sumitomo buy huge quantities of copper and store it for a while in order to create an artificial shortage of the precious metal, thus driving up demand, before releasing smaller amounts on the commodities markets at extremely high prices. In 1998, Sumitomo paid US\$150 million to regulators without any admittance of knowledge or condoning the actions of its rogue trader.

**John Rusnak** was a foreign currency trader working for Allfirst, a US subsidiary of Allied Irish Banks (AIB). Rusnak had a trading limit of only US\$2.5 million but by 2002 he was betting up to US\$7.5 billion on currency movements. When US\$691 million went missing, along with Rusnak, AIB called in the FBI. The subsidiary was sold in late 2002 and Rusnak served over seven years in prison.

In 2008, **Jerome Kerviel**, a trader working for Société Générale in Paris, cost the bank approximately 4.9 billion euros after making an unhedged arbitrated trade on European futures to the value of a staggering US\$60 billion without the bank's knowledge. He was recently sentenced to three years in prison after he lost his appeal.

UBS lost US\$2.3 billion in 2012 after rogue trading by **Kweku Adobli**, one of its investment bank traders. Adobli had traded in excess of authorized risk limits and booked fictitious trades to hide his true risk exposures. He is now serving a seven-year sentence after being convicted on two counts of fraud.

All of these rogue traders have one remarkable thing in common: bonuses aside, none of them did what they did for personal financial gain, or to harm their employers. All of them claimed that their corporate environment drove them to take greater risk, to create more profits. These organizations would of course strongly deny such allegations, and indeed have done; some may claim instead that, while risk taking is encouraged within a controlled environment, little may be done to control an individual who is intent on ignoring their trading limits and hiding losses from management.



Dr Hans Breiter, the renowned expert in cognitive neuroscience, conducted a study which found that monetary gain stimulates the same reward circuitry as cocaine in the human brain. Professor Andrew Lo comments that in the case of cocaine, we call this addiction, but in the case of monetary gain, we call it capitalism!

The pressure then reverts back to the rule makers; how far should they go to inhibit risk taking within an organization, to control the instruments they trade, to mitigate the consequences of potential ‘bad apples’? Kerviel could have brought down Société Générale and Rusnak could have destroyed both Allfirst and its parent AIB; neither of those eminent organizations would possibly argue that they would have wanted risk taking to such an extent; that would be preposterous. Yet Leeson’s actions did bring down Barings.

These examples all resulted from unauthorized and secret actions by employee traders. The shocking fact is that these are only a handful of real-life examples; there are countless more of them, some comparable in size, some much smaller, but many, many more exist and have not come to public knowledge.

The economist and philosopher John Maynard Keynes wisely once said that ‘Capitalism is the astounding belief that the most wickedest of men will do the most wickedest of things for the greatest good of everyone’.

## The culture of the Ponzi scheme

We’ve all heard of the Nigerian e-mail scam. Send someone \$1,000 and get \$50,000 back, or something like that. Only a fool would fall for that scam so the story goes, yet people do, time and again, so the scam repeats and multiplies and reinvents itself. The potential rewards are so huge in relation to the probable downside risk that greed submerges logic even in the most intelligent of victims.

Expand the scam to a gigantic scale, put in the centre of it the former non-executive chairman of the NASDAQ stock market and almost US\$65 billion in missing funds (including fabricated gains) from investor accounts, and you have Bernie Madoff. Actually, the final net loss to investors may ‘only’ be somewhere between US\$12 billion and \$20 billion, but this is still the biggest known financial fraud in history. In sentencing Bernie Madoff, the judge commented that his crimes were ‘off the charts’ since federal sentencing guidelines for fraud only go up to US\$400 million in losses.

The mechanics of the Madoff Ponzi scheme were very simple. Once Madoff had determined the appropriate return for each investor, false trading reports were created from false trades from a previous date, creating the amount of desired fictitious profit. If customer redemptions were required, then the monies would simply be accessed via a bank account from their and other investors’ funds.

However, this was a multi-billion dollar wealth management business with virtually none of the major derivatives firms trading with it, or Wall Street firms investing in it, because the high-ranking executives in those firms had their suspicions that it was not legitimate. Additionally, the financial analyst Harry Markopolos informed the SEC in 1999 that he believed it was legally and mathematically impossible to achieve the gains Madoff claimed to deliver. He was ignored by the Boston SEC in 2000 and 2001 and, after presenting further evidence, by the New York SEC in 2005 and 2007.

Also, this multi-billion dollar investment business was being serviced by an accounting and auditing firm with only three staff, of which only one was an accountant.

Hindsight is always easy, but there were plenty of red flags for the regulators to have acted long before they did. In fact, not long before the scandal of Bernie Madoff, in 2008, the Bayou Hedge Fund founder and star trader, Sam Israel III, had been convicted of defrauding investors out of US\$450 million (the net losses probably being closer to US\$75 million) and sentenced to 20 years in prison (increased to 22 years in 2009 after absconding and faking his own suicide) following the 2005 collapse of Bayou.

In his outstanding book, *Octopus: The Secret Market and The World's Wildest Con*, the true-crime journalist Guy Lawson comments at the end that he is convinced that Israel is sincerely remorseful for his actions and regrets the losses suffered by Bayou's investors. The fraud started with a 'small' lie, a few hundred thousand dollars misstatement in published investment returns in order that the few investors which Bayou had at that time would not withdraw due to poor performance. The fraud ballooned beyond imagination as the hole grew bigger and bigger; Israel and his conspirators were forced to create a complicit accounting firm to validate the returns, while new investors began a steady rush to the fund attracted by the steady and consistent published returns.

Sam Israel resorted to increasingly far-fetched and bizarre investment methods to retrieve the position – there was an underlying desire to make good to his investors, to recover the fraud, just like an unauthorized trader doubling down and risking everything. Eventually, he bet the house on a prime bank con ('Octopus' being the nickname for the secret bond market only known and open to a few 'lucky' privileged investors), the sort of which bore all the hallmarks of an inflated Nigerian e-mail investment scam. The rogue trader, Ponzi scheme fraudster, had fallen for the most basic of frauds though his own desperation and greed. Israel failed to recover the missing monies in time and suspicious investors demanded their investments back. Bayou collapsed amidst a failure to meet redemption requests and a raft of legal, regulatory and criminal investigations.

Israel apparently shares the belief with many commentators that such investment frauds and Ponzi schemes were rife prior to the 2008 financial crisis. Ironically, the collapse of the markets probably gave plausible explanation for similar funds to hide inflated returns amongst genuine widespread investment losses.

Ponzi schemes bring all the elements of capitalist greed together: unethical corporate culture, individual acts of fraud and the rogue trading addiction to bigger and bigger bets while concealing huge losses.

## The role of the risk management function

Risk managers of large, complex organizations now have an unenviable role. Not only are they tasked with designing, implementing and monitoring a risk framework within the organization, but they have to keep abreast of the multitude of new regulations that are being spat out by our lawmakers in response to public demand to control the banks who led the global economy into its current crisis.

The Dodd–Frank Reform Bill – all 2,319 pages – was signed into law on 21 July 2010, six months before the US Financial Crisis Inquiry Commission submitted its report and well before economists developed any consensus on the crisis. Would regulators approve a drug before its clinical trials were concluded, or the air authorities adopt new regulations in response to an airplane crash before the accident investigation had been completed? Add the euro crisis and new capital requirements for banks and other financial institutions, and risk management departments are facing moving targets just to keep their organizations merely ‘competent’ in tackling operational risks.

The extent to which risk managers can influence the control of the culture of greed within an organization and the excessive (fraudulent) greedy behaviour of individuals within the organization is highly dependent upon the culture of the organization itself. Many organizations espouse their risk management functions, but behind the glossy manuals and organizational charts, corporate attitudes to them can be vastly different. There needs to be a sense of empowerment within the function, an ability to influence through monitoring of risks and mitigating of exposures; in other words, risk management needs to be embedded within the culture of the organization.

The risk management function cannot be expected to determine the organizational culture, but, once empowered, it can have significant influence on the implementation of controls to prevent fraudulent behaviours.

The euro crisis has brought an onslaught of increased criminal activity. This is not surprising in view of the high levels of unemployment in southern Europe, the squeeze on employee pay and destruction in value of staff pensions. With pay cuts and job insecurity the norm, the doors of the banks are left wide open for organized crime to walk through – providing a malevolent influence within the organizations themselves.

Dual controls, segregation of duties, remote and on-site audits, checks, controls and procedures all provide parts of the toolbox for the risk manager to mitigate the risk of an employee determined to commit fraud. The purchase of insurance may also provide some mitigation of risk and can be built into the operational risk model and capital pricing.

## Insurance as a potential risk mitigant

Crime insurance, sometimes known as ‘bankers blanket bond’ or similar, is one obvious method of mitigating the effects of a determined fraudster. With the right conditions and appropriate indemnity limits, regulators have been known to allow some capital mitigation for operational risk for the purchase of such insurance.

However, crime insurance will rarely extend to the unauthorized trading loss – most insurers taking the viewpoint that such actions are the fundamental business risk of the banks themselves; the traders are there to generate profits and the controls need to be embedded within the organization to prevent undue business risk (breaches of trading authority) taking place.

Some of the larger banks do continue to purchase errors and omissions insurance (often referred to as professional indemnity insurance) for their liabilities to third parties arising out of the professional services which they provide (including trading services). However, following mis-selling of retail financial products, investment banking scandals, negligent investment advice and many more besides, the cost of such insurance is fast becoming prohibitive for some – going beyond the relative cost of capital mitigation.

Increased focus over the last two decades has been on directors' and officers' liability insurance, which covers the managers of an organization for their potential personal liabilities arising from them carrying out their roles. Some cynics have called this the insurance coverage for when failure has already happened and management needs to protect itself from resultant litigation. A more realistic sentiment may be that this insurance demonstrates the reality of our litigious world where directors and managers within an organization will now be held responsible for their actions to the owners of the business – the shareholders. Those actions may include the implementation of effective risk management controls and procedures; and could even include the decision to purchase or not purchase sufficient insurance.

Directors' and officers' liability insurance (D&O) is now viewed as vital for any sizeable organization, particularly if the entity wishes to be able to attract high-quality non-executive directors and senior staff. Increasingly, lawmakers have been keen to try to hold those running businesses personally responsible for the decisions they are taking. Therefore, while there will be no capital relief motive available for risk managers to use as justification for the purchase of D&O, it is undoubtedly a key mitigant for the management of risk.

## Conclusion

Greed, or the desire to make money, is what drives capitalism in the corporate world. However, we, as the public, taxpayers, shareholders and as society, have a right to expect the implementation of reasonable controls to prevent an abuse of power, the success of unfettered greed over prudent capitalism.

Arthur Andersen's collapse highlighted the conflicts of interest that exist in auditors' relationships with their clients. New rules have gone only some of the way to mitigate the conflicts, but there is still a widely held view that the big auditing firms remain too powerful and are allowed to indulge in significant fee-generating ventures not linked to their core service.

Increasingly the onus falls largely to the owners of our financial institutions to regulate the culture in which the businesses operate. The sometimes controversial Eliot Spitzer rightly argued that 'shareholders have the right and obligation to set the parameters of corporate behaviour within which the management pursues profit'. Therefore, the shareholders need effective management within organizations to protect their interests. Primarily, this falls to the non-executive directors, and the last decade has seen a dramatic cultural change as to their role. Their roles are now regarded as specialists and experts, equally likely to be held liable for their (in) actions. They too rely on testing the organizations' second and third lines of defence,

the risk management function therefore being critical to the protection of shareholders' interests.

Ultimately, it is vital to get the corporate culture right, and determine acceptable behaviours while still driving the desire to make money. As much as many would like, it is not possible to regulate culture per se. Individuals within an organization create and embed the culture and only the individuals can change it willingly, while regulators and lawmakers attempt to force it.

It may not be feasible for a risk manager to determine whether the risk culture of an organization is appropriate, but an organization can empower them to manage the framework within which they control the unacceptable risks facing the organization and its shareholders. History shows us that those risk managers who are not empowered, who are overridden by the culture of corporate greed, will find themselves isolated and impotent.

## Note

- 1 Prepared for *Handbook on Systemic Risk*, edited by JP Fouque and J Langsam



Absence Management  
Aviation  
Cash in Transit  
Commercial Combined  
Commercial Crime  
Construction All Risk (CAR)  
Cyber Liability  
Directors' & Officers'  
Directors' & Officers' – Side A DIC  
Employers' Liability  
Employment Practices Liability  
Energy  
Environmental  
Equine  
Equipment Breakdown  
Erection All Risk (EAR)  
Errors & Omissions  
Excess Casualty  
Fidelity Guarantee  
Financial Institutions  
Fine Art  
General Aviation  
IPO  
Inherent Defect Insurance (IDI)  
Investment Managers' Insurance  
Jewellers' Block  
Kidnap & Ransom  
Life Science  
Livestock  
Machinery Breakdown (MB)  
MBBI  
Marine Cargo  
Marine Hull  
Marine Liability  
Marine Risk Engineering  
Offshore Energy  
Onshore Energy  
Pension Trust Liability  
Political Risk and Trade Credit  
Ports & Terminals  
Primary Casualty  
Private Equity Venture Capital  
Product Recall  
Professional indemnity  
Property  
Property Damage/Business Interruption  
Property Named Perils and All Risks  
Specie  
Surety  
Trade Receivables Insurance  
Valuables  
War, Terrorism and Political Violence  
XL EuroPass – Global Program  
XL GAPS – Risk Engineering  
XL GlobalClaim  
XL WorldPass – Global Program  
\*

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