



Greed and Corporate Failure

CFA Society of Istanbul, April 15th 2009

Professor Stewart Hamilton

The current crisis



We don't learn.....

“There can be few fields of human endeavour in which history counts for so little as in the world of finance.”

J K Galbraith “A Short History of Financial Euphoria”

HOW SAFE IS YOUR COMPANY? Lessons from recent financial disasters

- Barings Bank
- Metalgesellschaft
- Bankers Trust
- BCCI
- Maxwell pensions
- NatWest Markets
- Kidder Peabody
- Showa Shell
- Daiwa Bank
- Sumitomo
- Deutsch Morgan
Grenfell Asset
Management

The next high profile disasters

- Enron
- WorldCom
- Global Crossing
- Tyco
- TXU Europe
- Marconi
- Swissair
- Parmalat
- Hollinger
- HealthSouth
- Asia Pulp and Paper
- Northern Rock
- Skandia
- Allied Irish Bank (Allfirst)
- Ahold
- HIH Australia
- Equitable Life
- Adelphi
- Refco
- ABB
- Fannie Mae
- China Aviation Oil
- Société Generale

No public accounting firm has clean hands!

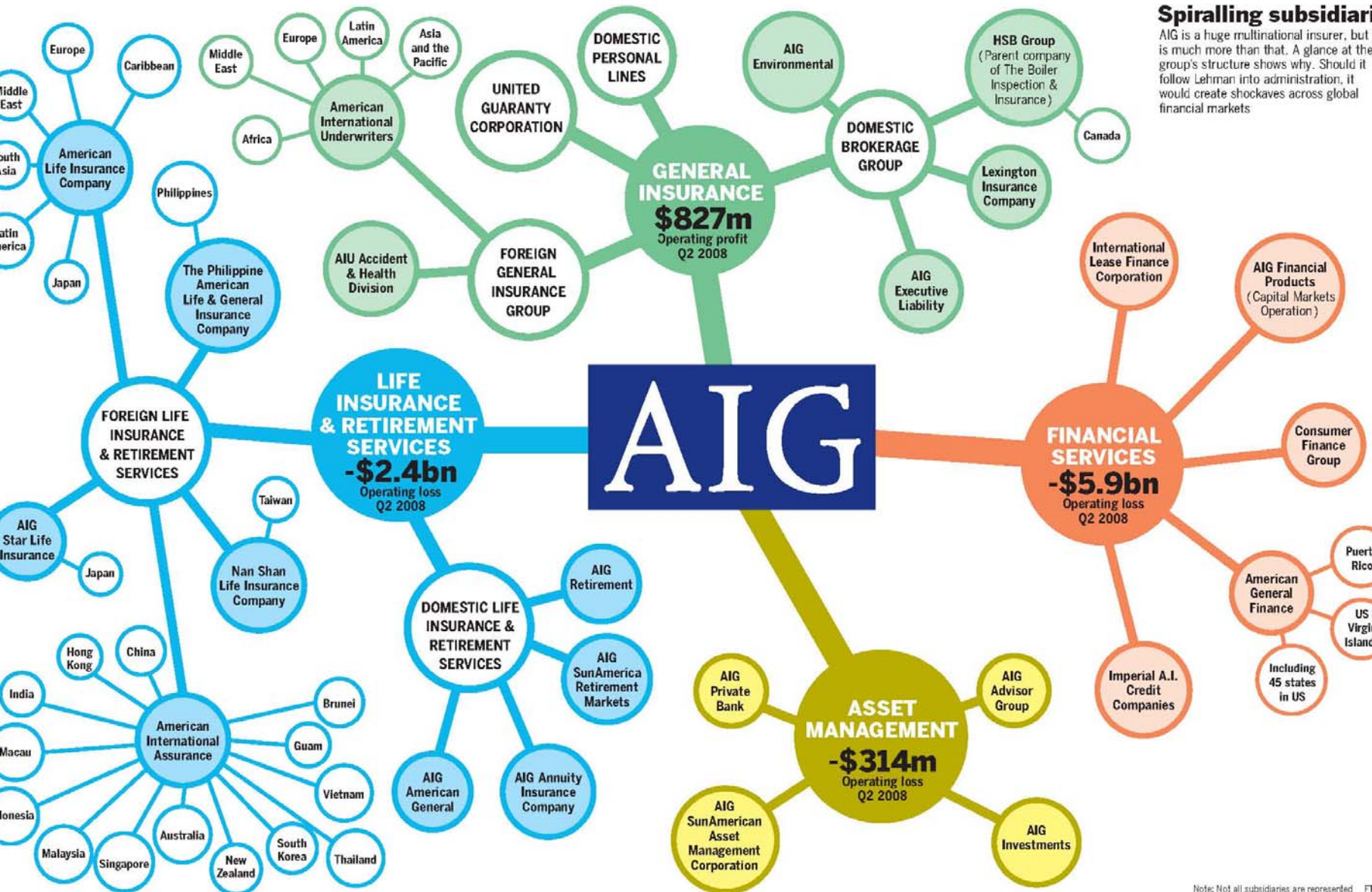
This time around, casualties so far include.....

- Bear Sterns
- Lehman Brothers
- Wachovia
- Washington Mutual
- Merrill Lynch
- Fannie Mae & Freddie Mac
- AIG
- UBS
- Royal Bank of Scotland
- Bradford & Bingley
- HBOS
- Fortis
- Dexia
- Hypo Real Estate

Who or what is to blame? The list is long.....

- Senior management
- Boards & Audit Committees
- External Auditors
- Regulators (Stock Exchanges & Central Banks)
- Rating Agencies & analysts
- Politicians
- Vast increase in proprietary trading by banks (their own money at risk)
- Remuneration packages focused on short term “success” significantly increases risk taking
- No penalty for failure

- And, above all, **GREED**



Spiralling subsidiaries
AIG is a huge multinational insurer, but is much more than that. A glance at the group's structure shows why. Should it follow Lehman into administration, it would create shockwaves across global financial markets

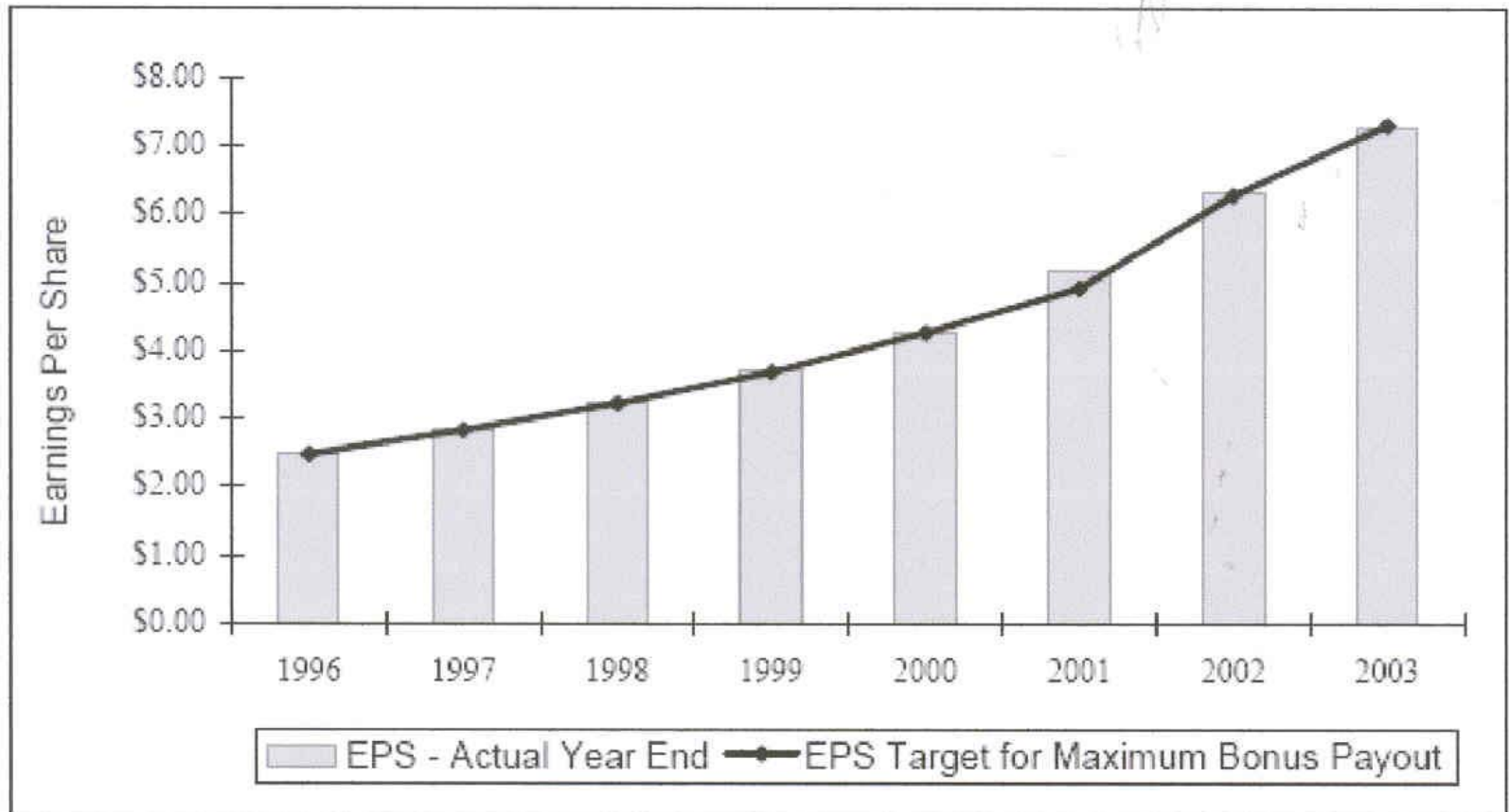
To an editing error, an earlier version of this graphic erroneously showed that the general insurance division made an \$827m operating loss in the second quarter of 2008. In fact, the division made an \$827m operating profit. We apologise for the mistake

Note: Not all subsidiaries are represented FT

(7000 legal entities in 150+ countries)

Fannie Mae earnings manipulation

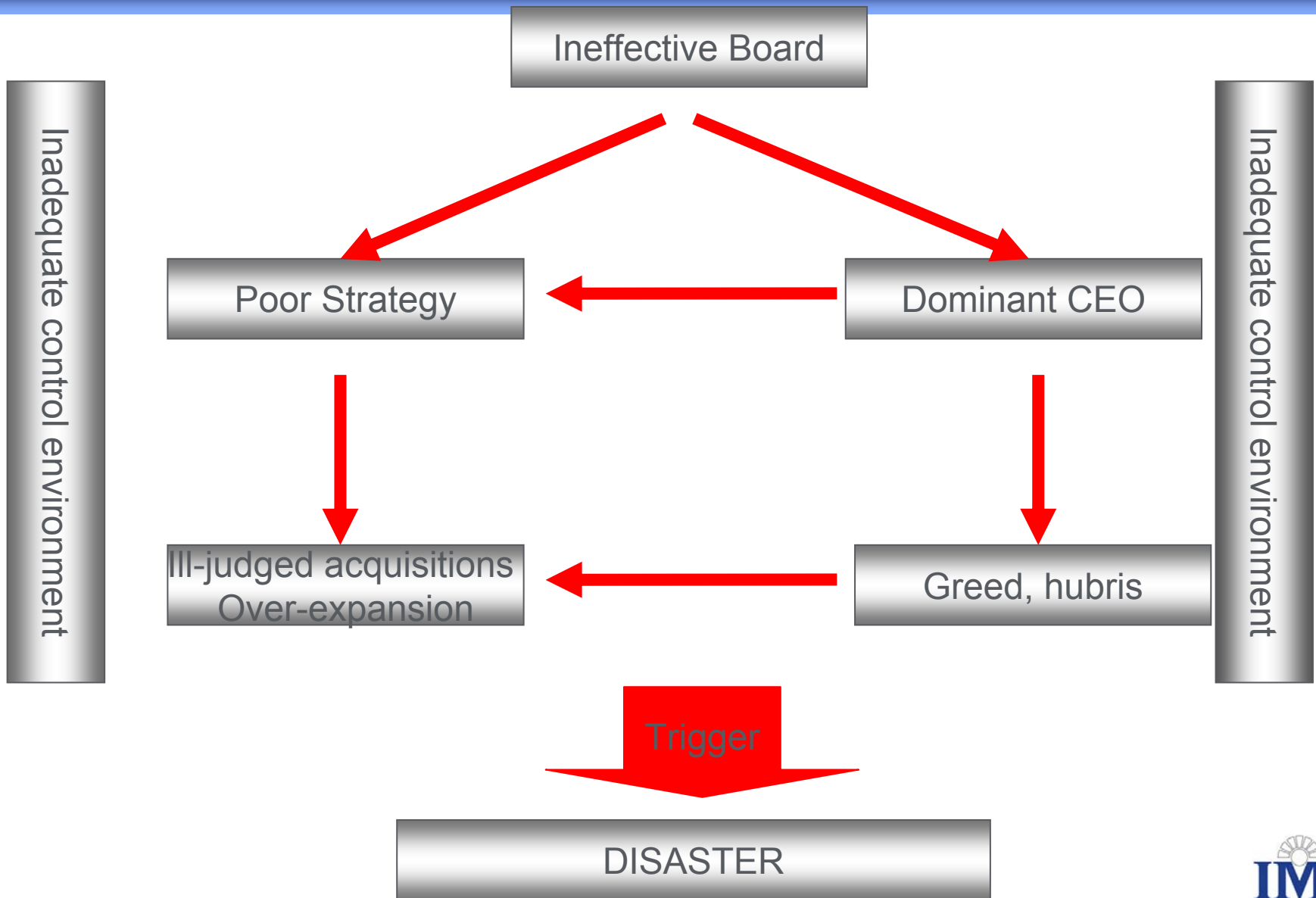
Figure V-1: Maximum Bonus Payout Targets and Reported Earnings per Share (EPS), 1996-2003



Six Inter-linked Causes of Failure

- Ineffectual or ineffective boards
- Poor strategic decisions
- Overexpansion and ill-judged acquisitions
- Dominant CEOs
- Greed, hubris and the desire for power
- Failure of internal controls

The Downwards Spiral



Ineffective or ineffectual boards

- Enron
- WorldCom
- Swissair
- Tyco
- Parmalat
- Barings
- Fannie Mae

Analysts' Recommendations

Strong buy		33.9%
Buy		35.5
Hold		29.7
Sell		0.7
Strong sell		0.2

Survey of 27,700 individual stock recommendations by analysts

Source: First Call; Thomson Financial, October 1, 1999

Quoted in the *Financial Times*, 27 October 1999

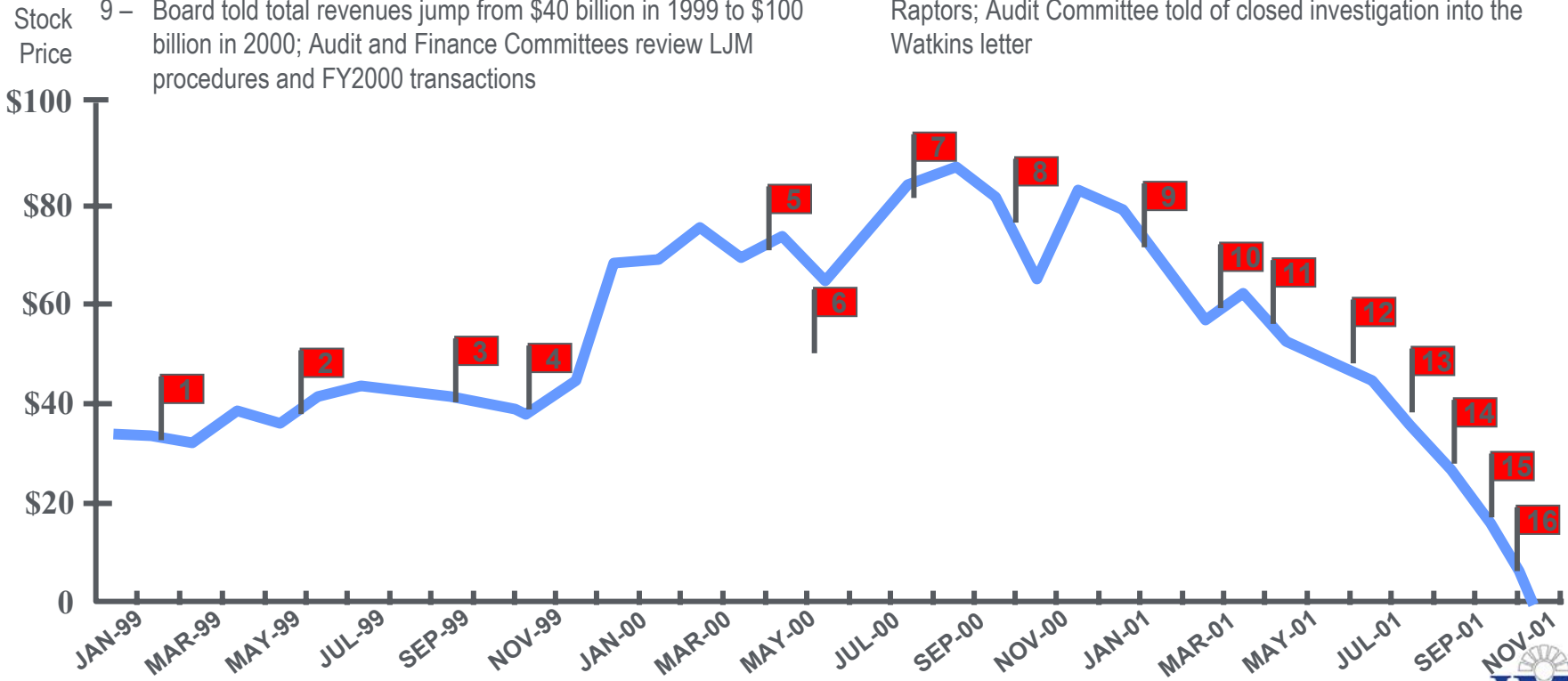
The role of the Board of Directors in Enron's collapse

- Fiduciary failure
- High risk accounting
- Inappropriate conflicts of interest
- Extensive undisclosed “off the books” activity
- Excessive compensation
- Lack of independence

Source: Report of the Permanent Subcommittee on Investigations
of the Committee on Government Affairs, United States Senate July 8, 2002

“RED FLAGS” KNOWN TO ENRON’S BOARD

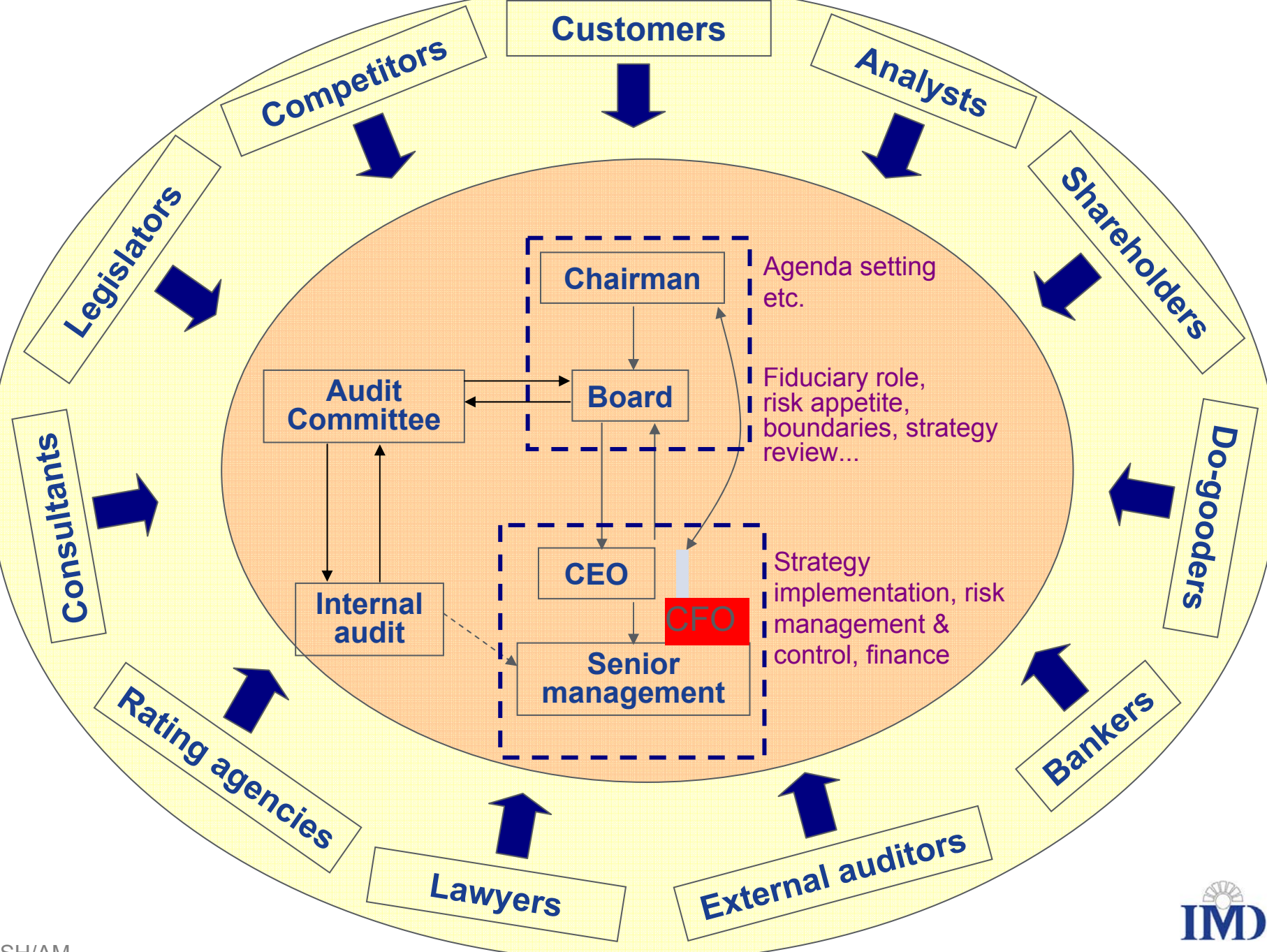
- 1 – Audit Committee told Enron accounting practices “push limits”
- 2 – Board approves Fastow’s Code of Conduct waiver for LJM1
- 3 – Whitewing moved off-balance sheet with \$1.5 billion
- 4 – Board approves second Fastow waiver for LJM2
- 5 – LJM2 update: “Q41999: 8 days/6 deals/\$125 million”; \$2 billion in funds flow to Enron; Board approves Raptor 1
- 6 – Executive Committee approves Raptor II
- 7 – “Project Summer” to sell \$6 billion in assets fails; Board approves Raptor III/IV
- 8 – Board approves third Fastow waiver for LJM3; Board told \$27 billion in assets off-balance sheet
- 9 – Board told total revenues jump from \$40 billion in 1999 to \$100 billion in 2000; Audit and Finance Committees review LJM procedures and FY2000 transactions
- 10 – Fortune article questions Enron’s earnings and accounting
- 11 – Board told 64% of international asset portfolio “Troubled” or “Not Performing”; 45 million Enron shares at risk in Raptors and Whitewing
- 12 – Board told of \$2.3 billion deficit in market value of Enron’s international assets
- 13 – Fastow sells interest in LJM to Kopper
- 14 – Skilling resigns; Finance Committee told of \$6.6 billion in prepays and FAS 125 transactions
- 15 – Lay defends use of SPEs in online session with employees
- 16 – Finance Committee told of \$800 million earnings write-down from Raptors; Audit Committee told of closed investigation into the Watkins letter



A heavy agenda...

- Report reviewing Enron's GAAP compliance and internal controls
- Report on adequacy of reserves and related party transactions
- Report on disclosure of litigation risks
- Report on Enron's 2000 financial statements
- Discussion of revision of Audit & Compliance committee charter
- Review of 2001 Internal Audit control plan
- Review of policy for communication with analysts
- Impact of Regulation Fair Disclosure

Enron Audit Committee, 21 February 2001



Rules as a threat to good governance?

“Boards need to ensure that they are making the most effective use of limited time and knowledge in order to achieve their stated objectives rather than simply complying with the letter of corporate governance codes”

Source: The Chartered Institute of Management Accountants
“Enterprise Governance – Getting the Balance Right”

Key lessons

- Ethics matter!
- Manage expectations, not earnings:
 - Realistic target setting
 - Don't oversell
 - Clear and consistent message
- If it looks too good to be true, it probably is!
- Link remuneration to long term objectives
- Do your own homework (due diligence), especially in new areas
- Invest sufficiently in information and control systems

Recommendations

- Separate roles of Chairman and CEO
- Don't promote CEO to Chairman
- Improve role of the audit committee
- Break up “Big Four” audit firms
- Re-align executive compensation to longer term targets (more than one!)
- Increase shareholder participation
- End rating agencies oligopoly

And the underlying lesson again....

“Profit is an *opinion*, cash is a *fact*”