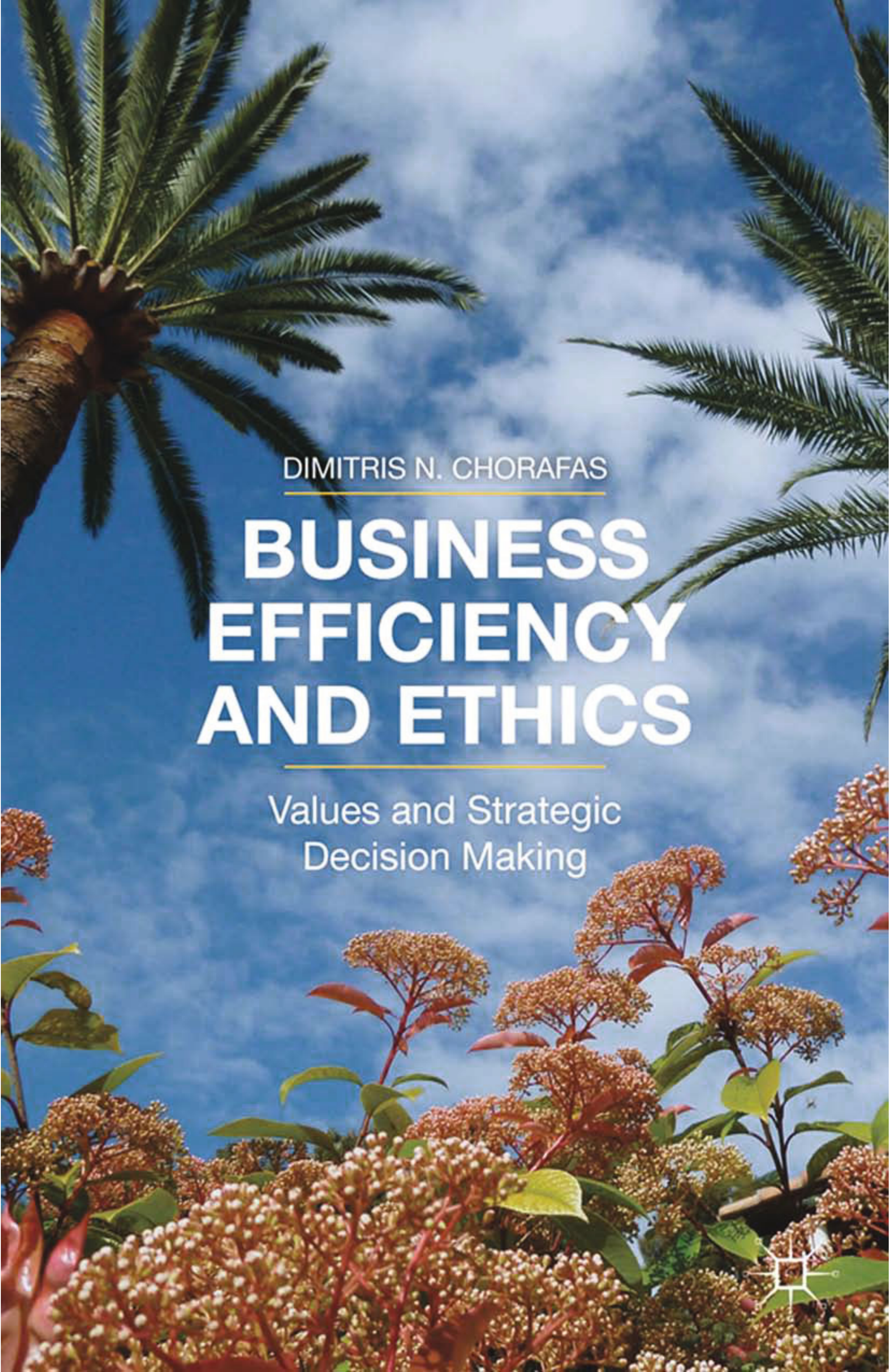
DIMITRIS N. CHORAFAS
BUSINESS EFFICIENCY AND ETHICS
Values and Strategic Decision Making

Business Efficiency and Ethics

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Business Efficiency and Ethics

Values and Strategic Decision Making

Dimitris N. Chorafas

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Foreword

For more than five decades, Dr. Dimitris Chorafas has studied, analyzed, and advised financial institutions and industrial corporations in areas that have mattered most to them: strategic planning, risk management, computers and communications systems, and internal controls. Along the way, he has authored 160 books, many of which have been translated into several languages and are known to a wide public of sophisticated business leaders around the world.

Now, he turns his attention to the single area of business that matters most to us: its *ethics*. In today's complex, competitive, large and often impersonal enterprises, the small, still voice of virtue can barely be heard.

Armed with the perspective afforded by long experience, Chorafas confronts the woeful failings of today's business environment with the oldest, most basic tenets of human wisdom. We all know, and theoretically espouse, the distinctions between what is right and wrong in human conduct, and yet in the past few decades we have seen scams and scandals of poor governance, malpractice, corruption, inefficiencies, and bankruptcies—"A Stew of Sorrows and Deceits," as he calls it—on a scale hitherto unimagined.

Chorafas channels this sense of outrage into an illuminating analysis, peppered with lively contemporary examples, of the greed, incompetency, and inadequacies of the business environment, and forcefully reiterates basic values: transparency, leadership, trustworthiness, and, above all, the decisive role of character.

Chorafas is no preacher—though the absence of reaction by religious leaders to this ethical morass has not escaped him. Endowed with the lucidity and specificity of his training and experience, he takes on the predations of insider trading, the "too-big-to-fail" policies and resultant dearth of criminal prosecutions, managers' excessive pay and extravagant bonuses, the absence of risk control, the ruinous impact of "an economy based on steroids," various ill-conceived ventures in the globalized economy, and much more. From the height of his age and wisdom, he does not need to beat about the bush; honest and outspoken, he reviews the failings and quandaries that beset large segments of the business world today and offers expert insight and guidance.

On a personal note, I became acquainted with Dr. Chorafas through his philanthropic activity, namely, the international awards he funds for students in the sciences. Surely, a good measure of character is not only earning one's money honestly, but also spending it wisely, in keeping with deep and abiding values.

Professor Israel Bar-Joseph
Vice President for Resource Development
The Weizmann Institute of Science
Rehovot, Israel

Preface

This book addresses the current challenges in management and finance in regard to business efficiency and the ethical dimension. The text provides an answer to crucial questions raised by academics and professionals, as well as by the wider public during the economic crisis that started in 2007 and the Great Recession that followed it. Its strength is the case studies, data, and examples that illustrate the challenges confronted by management in an increasingly complex market environment.

Business efficiency and ethics is generally thought to be fair dealing with other people. For example, being thoughtful and productive, never making false promises about products and services, avoiding obligations you know you wouldn't or couldn't keep, and so on. But in reality business ethics starts with delivering an honest day's work. This is the principle I learned nearly six decades ago during my postgraduate studies at UCLA and never had any regrets in applying.

In its most fundamental definition, business efficiency concerns the practices of a person who recognizes his or her mistakes early on. We all make mistakes, but are we aware of them? Are we learning from them to avoid repeating them? Are we taking all necessary steps to correct them before the magnitude of their effects increases and becomes harmful to ourselves and to others? Are we avoiding corrupt practices? Corruption is a poison afflicting daily business life in companies and in government.

A violation of business ethics and of efficiency principles is the practice of *deliberate indifference* whose bearing goes well beyond the aforementioned examples. Tepco's attitude in Japan's nuclear tragedy and BP's indifference to safety in the Gulf of Mexico deep water oil spill document the negative side of poor business decisions. According to UN Global Compact standards, both companies had low social and environmental ratings—and both have demonstrated that deliberate indifference can have a real impact:

- On business, and
- On society at large.

Ethical values and efficiency correlate between themselves and with business effectiveness. Social ethics are in retreat when confronted by a mounting amount of managerial indifference. As this text will demonstrate, through case studies and practical examples, ethical and efficiency challenges exist in a wide range of activities, from public administration to the financial industry, to manufacturing and services.

Written for academics and professionals, this book underlines the need for taking a broader view of business ethics, of efficiency and of their positive aftereffects. *Man-made*, or technical, disasters happen because professionals don't care about, or at best don't pay attention to, what they are doing. Yet, what they do and what they fail to do has the potential of catastrophic consequences.

Chapter 1 brings to the reader's attention the issues shared by efficiency, effectiveness, and ethics. It emphasizes the dividends to be obtained by virtue, defined by Socrates as knowledge that cannot be taught. Then, the chapter takes as an example of lack of ethics the Stars scam, which, a couple of years ago, shook the banking industry and had a lot of aftereffects.

Chapter 2 expands on chapter 1's themes by reminding the reader that managers, particularly senior managers, are in the front line of efficiency and ethics. Therefore, they have a great lot of accountability both for what their company is doing and for what it fails to do. Quoting some of the leaders of industry the text compares the actions of high-quality people and those characterized by poor governance or outright malfeasance. All sorts of people work in business and industry, and it is not that easy to fire the inefficient.

A company must make profits to survive the test of time as well as to have a war chest if adversity hits. But the company also has a clear responsibility to the community in which it operates. This responsibility is the theme of chapter 3. Trying to discharge it is a wrong-way policy, opening the way for corruption and leading to scandals in the boardroom.

As the green light for business scandals is usually given by a lax regulatory environment, the case studies presented in chapter 4 have to do with what this text calls the *absurdistan*'s domain. Not only does the civilian public administration allow itself to be taken for a ride, but highly paid military officers are also not as careful in their work and in their negotiations with rebellious forces as they should be.

Among the lives of the great and good, a distinguished position is taken by those who are able to think of the "unthinkable." Its nature is intriguing because it either happens for the first time or events relating to it appeared so long ago that they have been forgotten. Chapter 5 presents the reader with examples like debt forgiveness in the ancient world, crises in business confidence that hit when they were least expected, the aftereffects of the welfare state, unaffordable entitlements, and the deflation dragon.

Chapter 6 concentrates on ethics and efficiency in the financial industry. One case study it includes is that of Ivar Kreuger, the Swedish match king who built an empire in just a few years (in the 1920s) and then saw it swept away by the Great Depression and by his own overexposure to risk. This and the other cases included in the chapter teach lessons that can help the reader avoid similar mistakes.

The case studies in chapter 7 are the Libor scandal, which continues to overshadow the banking industry, the problems confronted by exposure to derivatives, and the deceit that hit the gold market as well as the gold mining industry. All of these events have kept the supervisory authorities in the US and Europe busy. Therefore, they constitute excellent examples of how situations that seem to be right turn out to be wrong.

Chapter 8 goes a step further by demonstrating the risks associated with companies trying to capitalize on the casino society. This may be disastrous to careers, like the case of MF Global that hit the news in the US because of the persons involved in it. A similar case in Europe is that of Dexia, the Franco-Belgian bank that, in the course of a few years, went against the wall twice and was finally dismantled at great cost to the taxpayer. This chapter also discusses the risks associated with securitized products and with securities lending at large.

The rise and fall of Barings, the well-known British bank, is chapter 9's theme. "Risk-free" profits exist only in dreamland; a global bank is not expected to cook the books as Barings did. Star trades who make extraordinary bonuses and a name by amassing losses that they ingeniously hide through creative accounting, must know that the day of judgment inevitably comes and they will lose everything in terms of wealth and name—being left with only a prison term.

The rise and fall of Parmalat is discussed in chapter 10. Theoretically, it was an Italian dairy products company. Practically, after its president discovered how to benefit from political patronage and how easy it was to take banks and governments around the globe to the cleaners, Parmalat became a worldwide hedge fund. The name of its game was deceit.

The mismanagement of efficiency and effectiveness is not only the financial industry's problem. It can also be found all over the manufacturing industry. Therefore, it has been a deliberate choice to include in chapter 11 several examples from different industry sectors—companies like Kodak, BlackBerry, Hewlett-Packard, Fiat, General Motors, Motown, and the so-called flag bearers.

Marketing failures are the high point of deadly mismanagement but excesses in design also contribute to the brewing troubles. In March 2014 Martin Winterkorn, Volkswagen's boss, warned that the increasing integration of smart technology into cars risked creating a "data monster." *The Economist* put it this way, "Smart cars have gadgets that link easily with smartphones, but other features, such as in-board cameras and systems that can alert insurers to aggressive driving patterns, are worrying privacy advocates. Winterkorn says "yes to Big Data but no to Big Brother."[1] Who would argue with that?

Recently, Big Brother has chosen to reside in the Internet as a number of scandals and spying scams document. But as chapter 12 brings to the reader's attention, the most immediate threat is lack of security. The security characterizing information technology is low—too low to be good for society. From the customer files stolen from the Target supermarkets and eBay in the US to the pirated bank accounts in Germany and massive theft of credit card numbers in South Korea there exists plenty of evidence that hackers have a field day.

* * *

In practicality all the cases this book brings to the reader's attention, inaction, particularly when confronted by an impending disaster, is evidence of the lack of business ethics, absence of efficiency, and plain indifference. Insurance companies say that the result of inefficiency and indifference is demonstrated by major fires, explosions, aviation disasters, shipping and rail disasters, mining accidents, and the collapse of buildings and bridges. Other disasters are due to the complexity of novel financial instruments; faulty design of hardware products; malfunctioning software routines; and substandard, obsolete, or unreliable information system applications.

As with natural catastrophes, man-made disasters damage reputations. Typically, they end up in financial losses as well as risks associated with people, vehicles, buildings, infrastructure, and other assets indispensable to a civilized society. One of the risks repeatedly found with poorly designed and implemented information systems, for example, is the interruption of business and its aftereffects.

The nondelivery of important services also has other consequences such as environmental pollution or impaired quality of life. It may as well involve liability toward third parties, suing for damages, and court action with associated reputational risk and financial losses. For these overriding reasons the present book brings to the reader's attention not only the principles underpinning business and professional ethical behavior and efficiency measures but also plenty of examples outlining the damage created by the:

- Absence of ethical values, and
- Personal inefficiency or indifference.

Documentation is provided by means of case studies and references that underline the importance of reestablishing appropriate business behavior standards. This course of action has been chosen in the belief that practical examples are the best way to explain *what ethics and efficiency mean*—and to demonstrate why this issue is so important to every person, to every company, and to society.

* * *

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July 2014

Dimitris N. Chorafas
Valmer and Entlebuch

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1

Ethical Values, Efficiency, and Effectiveness

1. *Areté*: Virtue Is the Foundation of Ethics

To the ancient Greek philosophers *areté* (virtue) meant excellence, bound with the fulfillment of purpose or function. The way of reaching one's full potential is *efficiency*, and efficiency depends on the job one does and its deliverables. You cannot be efficient unless you take the trouble to learn the job and then be willing and able to deliver an honest day's work prior to asking for compensation of your efforts.

By elaborating the concept of *areté* as a guideline, ancient philosophy turned its attention from *physics* (the natural sciences) to man's own self. Virtue was conceptually extended to cover a person's contribution to the society in which he was living. A basic question raised by Socrates, Plato, and Aristotle has been about the *ergon*, or function of man. This brought both efficiency and effectiveness in perspective (section 3).

- The emphasis on *ergon* promoted "virtue in the large," defining a person's place in society and his contribution to it.
- By contrast, the current meaning is "virtue in the small," limited to a person's behavior and his observance of laws and unwritten rules.

"Virtue in the small" is *ethics*, a moral philosophy recommending what is right in conduct within the broader context of society and the conscious or unconscious processes underpinning it. Ethics defines how one should act within a given societal setting with its laws, rules, and conventions. At the root of the word "ethics" is the Greek word *ethos*, which means character.

The present, which contains the roots and seeds of the future, is always loaded with the past. The link between past, present, and future is provided by virtue in the large, which is *meta-ethics*, addressing theoretical meaning, or moral acts, as well as the determination of truth values. *Normative ethics* are concerned with the practical way of elaborating a moral course of action; *applied ethics* focus on moral deliverables; descriptive or *comparative ethics* study people's beliefs about morality and evil, good and bad, right and wrong.

An integral part of ethics is individual freedom, evidently including the liberty of thought and speech. The concept of virtue should not be used to keep thinking and speech under lock and key. Fyodor M. Dostoyevsky, the Russian author of the human soul, was opposed to the movement of his epoch (mid- to late nineteenth century) that professed that social events and developments could be programmed or reprogrammed. In Dostoyevsky's opinion there existed no recipe for the creation of "the new man"—the way socialism and communism professed.

The basis of ethics is individual freedom, Dostoyevsky said.[1] His thesis takes the wind out of normative ethics, which is the study of ethical action. The purpose of normative ethics is to investigate the questions arising when contemplating how one ought to act according to prevailing morality. It examines standards for right and wrong actions, while meta-ethics studies the metaphysics of moral facts.

Normative ethics is also distinct from *descriptive ethics*, which is an empirical investigation of people's moral beliefs, hence rather prescriptive than descriptive. By contrast, a process known as *moral realism* looks at moral facts in a hybrid descriptive and prescriptive way, its downside being the admission of constraints and taboos that inhibit the continuous advance of culture and restrain its impact on civilization.

Normative ethics should neither be too soft to sustain social culture, nor too rigid to swamp free expression. Ideally, normative ethics should dictate the principles of truth and of transparency.

Truth is the best policy. But many people, and not only those in high places, do not like to admit the truth that they say violates the central tenet of political and financial life. Instead, they advise avoiding the use of a written and spoken language to convey a message. François Mitterrand, the late French president, believed that you get out of ambiguity at your own risk; he advised his assistants to never explain and never justify their acts.

I find it simply incredible that people get excited and sometimes aggressive when I speak my mind and tell them the truth about a bleak future, if things continue "as usual." This they should have been able to find out by themselves. Merely embracing the status quo is not ethics, because there may be many things going the wrong way and it is silly to ignore them. The facts surrounding *areté* are dynamic and that's the way to handle them. The trouble with misinterpreted *areté* is that we take too much for granted.

The concept of ethical behavior should not be confused with acting in line with social conventions or religious beliefs. The underlying concept is one of character (section 2). Virtue in the small is no stand-alone concept. It is an integral part of a person's behavior and it should not be used interchangeably with "morality" whose meaning tends to change from one society to another, as well as over time, to fit a particular tradition or developing situation.

The *ontology* of ethics is concerned about values and stuff referred to by ethical propositions. Some philosophers believe that ethics does not need a specific ontology, but the pros insist that there must be a system to explain what kind of properties or states are relevant for ethics and also how to value things and motivate actions. In this sense the ontology is accompanied by a philosophical approach to higher-order questions about ethics.

This does not exclude the fact that people use ethical propositions as a screen for their not-so-ethical acts. A research project, reported the *Daily Telegraph*, has come to the conclusion that almost half of the psychologists have massaged the results of experiments to obtain a desired outcome. Nearly one out of two scientists questioned for a survey admitted having reported the only results of an experiment that supported *their* theory or position.

Some 43 percent of the interviewed scientists said they had decided to exclude data from one or more of their studies, while 35 percent had reported an unexpected finding *as if* it had been expected all along. A small 2 percent admitted actually faking their data, which is far from being an ethical practice no matter how one looks at it.[2]

The common ground for all the references made in the preceding paragraphs is that virtue describes the character of a person as a driving force, with an inclination toward ethical behavior. Socrates was one of the first ancient philosophers to encourage both archons (leaders) and common citizen to turn their internal attention from the outside world to their ethical condition, while insisting on the fact that *areté is* knowledge that cannot be taught.

- Knowledge was considered an inherently essential good, necessary for success in life.
- But self-knowledge and the assumptions we gradually make automatically, was placed higher.

A self-aware person will act using his abilities in the best possible way. By contrast an ignorant person will flounder and encounter difficulties in making up his mind. In the opinion of ancient Greek philosophers, to attain self-knowledge a virtuous person must be aware of every event and its context. Improper actions and low ethical standards are the result of ignorance.

This approach has been instrumental in correlating knowledge with virtue and with efficiency, while learning how to learn constitutes the background. Learning is, as well, the teaching of the Buddha, whose dictum has been that we should live each day *as if* it is the last day of our life but we should learn *as if* we will live forever.

Learning must overcome problems of evidence, interpretation, explanation, and assimilation. We can learn much more from failure than from success. In fact, success and failure are not absolute opposites. Not only can failure be a better teacher than success, but turning failure into success is also a sign of creativity.

A creative attitude toward failure can help to avoid a tandem of other faults and weaknesses. When, in 2006, Alan Mulally became the CEO of the ailing Ford Motor Company, one of the first things he did was to demand that his senior executives describe their failures. He then expressed astonishment at being confronted by an absence of failures revealed by this self-critical process, though in the previous year Ford had lost several billion dollars.

Success, too, must be carefully watched because its aftereffects fade fast if there is no follow-up, no matter what the reason for delays. Hardly have we built the arches of bridges and clauses of the law that time starts straining them. The efficiency side of *areté* requires careful watching out for stress signs, with measures taken to right the balance before the damage spreads. This is a "virtue in the large" responsibility.

2. Character Is the Main Asset of Trustworthy People

In a wide range of situations, including investments and trading, transparency is the best policy. Phil Tindall, a senior investment consultant at Towers Watson, says: "The best types of strategies are those that are more transparent, straightforward and easy to understand…It's really important for (the clients) to understand the characteristics: the simpler the product, the easier it is to know what you are buying."[3]

The keyword in Tindall's quote is *understanding*, which is just as vital whether the situation is good or bad. Character plays a decisive role in understanding and appreciating a situation. Most of the triumphs of people faced with adverse conditions are won by the person's character rather than his intelligence, as Siegmund G. Warburg, the banker, advised his customers, associates, and assistants, adding: "High quality people find it easier to pardon others than to pardon themselves."[4]

As in the Ford example in section 1, the worst that can happen to any organization is auto-satisfaction, because it leads to negligence and to lack of interest in what one does. Unlike common sense, however, personal discipline and drive are not universally distributed.[5] People are either very demanding of themselves or satisfied with themselves no matter what they are doing.

- People who question the value of their deliverables are those who contribute to progress, including their own advance.
- The real winners in life typically face great challenges and turning points; they win by concentrating on them and overcoming them.

Those who are satisfied with themselves and their condition rely on lies (to themselves) to make things sound wonderful. The worst lie politicians can nowadays say, and the common citizen repeat, is the illusion that Western countries are "rich." They are not. An equally bad lie is to believe that it is possible to change the current depressing economic and financial situation by keeping things as they are, only giving the impression that one is favorable to change but not right now, sometime later on, which practically means never.

This shows a character that leaves much to be desired because a clear responsibility of leadership is to explain that many things that move the wrong way must adopt a new course. The reasons may be varied: The present system may be too old in its concept, hence incapable of embracing the future; too inflexible in the way it works; too costly, hence uncompetitive; or too inefficient in its methods. Alternatively, the political leadership may wrongly believe there is something to be gained from tolerating defects or from accepting what the lobbyists present as god given.

The attitude described in the preceding paragraphs is a direct negation of what Warburg said on character, and because that sort of spirit has become widespread, society is dominated by the big lie. As an example, lobbying for pharmaceutical companies in the US has reached $1.2 billion per year. Compared to this, not long ago lobbying costs were "only" $800 million.[6] It is also interesting to note that big pharma has overtaken defense as the no 1 financier of political parties. The budget pharmaceutical companies put up to influence political decisions in Washington is 400 percent higher than defense—the next industry feeding the lobbying machine.

That's not the way to acquire new strength and new resilience. Too much greed is bad. Eike Batista, a Brazilian businessman, wanted to become the richest man in the world using EBX, his oil empire, as vehicle. The problem he encountered is that he entered business history from the wrong end, by losing $34.5 billion in one year—or $94.5 million per day,[7] a world record.

A special form of greed and an illegal practice, too, is insider trading. To improve their bottomline and that of their companies people engineer scams. Dr. Sam Waksal is the founder and former CEO of ImClone Systems. The government accused him of insider trading, perjury, bank fraud, and obstruction of justice. Waksal pleaded not guilty when he appeared in a New York court on August 12, 2002, but this did not help him.

Allegedly Waksal tipped off family members and friends, including close friend Martha Stewart, to sell their shares in ImClone shortly before publicly announcing that the Food and Drug Administration had denied approval for its star cancer drug, Erbitux. Also, he, allegedly, forged signatures on bank documents. Not only did the attorney general asked for a jail term for the former CEO, but ImClone also sued him over his severance pay.

Greed and trustworthiness are antipodes. Warburg has given a good example of how trustworthy people are brought up through a reference to his mother's family. When his mother was young, her father had advised her: "My kid, if you need to choose between two courses, ask yourself first of all which is the most difficult—because that's the one which will prove to be the better one of the two."[8]

Everybody is answerable for his actions, though many succeed in escaping the hand of justice. Companies that become aware of the fact that trustworthiness pays dividends try to rehabilitate their reputation by changing their internal rules for dealing with clients. At Goldman Sachs, the investment bank, a new set of rules is best summed thus: Nearly all clients (bar the biggest and smartest) have limits placed on the sorts of transactions they can undertake.

For example, municipalities are no longer allowed to buy or sell derivatives unless these are clearly matched by an underlying interest. Another recent policy is that of being more open with clients, telling them exactly how much they may earn from transactions (but not necessarily how much they can lose).[9] It may well be bad for business if clients are informed about potential losses, but when we talk of character and of ethical behavior this is a "must."The most exposed in highly leveraged deals that turn sour are the banks that conceive, design, and market them. To protect banks have been invented the "too big to fail" and "too big to jail" policies that make up the Geithner doctrine. Since the 2008 descent to the abyss of the banking industry, because of its self-inflicted wounds, the Geithner doctrine made the preservation of big banks a top government priority no matter the consequences—and the consequences have been severe. (In parallel to this, Geithner also allegedly approved Libor's manipulation by the big banks which developed into a major scandal; chapter 7.)

In an article he published in *The Financial Times*, Neil Barofsky points out: "Aside from moral hazard [the intervention in saving private banks through public money] has also meant the perversion of the US criminal justice system. The US faces a two-tiered system of justice that, if left unchecked by the incoming Treasury and regulatory teams, all but assures more excessive risk-taking, more crime and more crises."[10] Barofsky has been right in his assessment.

The government's benevolence toward big banks is easily demonstrated not only through the use of taxpayer money to refill the treasury but also by the stunning dearth of criminal prosecutions. The Geithner doctrine precludes it out of fear that a more aggressive stance against wrongdoers at big financial institutions could have a negative impact on the markets' stability. This is questionable, but a sovereign policy based on that assumption has made the biggest and wealthiest banks too big to fail and their executives too big to jail.

Not only are such policies making a business dealing, but also they help to demonstrate the precariousness of social policies which admit wrongdoers in their ranks and cover them by way of "too big to fail" policies. While political and economic threats can cause fundamental crises in society, more often than not they only reveal them. Their roots have been planted through decades of mismanagement that created:

- An artificial society, and
- An economy based on steroids.

The absence of reaction by religious leaders has also been a curious event. Its explanation may lie in the fact that like other social conventions, religion has little to do with virtue in the large though it has often left its imprint on virtue on the small.

Contrary to present-day religious practices, the ancient Greeks who were very much concerned with *areté*, hence with ethics, did not first assert the existence of god and then enumerate its attributes: "god is good," "god is alive." This has been invented by Christianity. Instead, when it came to character the ancients were impressed and awed by some things in life, attributing them to the gods (noun, plural): "Love is god."[11]

3. Efficiency and Effectiveness

Efficiency and effectiveness[12] are the pillars of *areté*. Each has two definitions complementing one another. Efficiency is doing a given job in the shortest possible time at the lowest cost, while upholding quality. The alternative definition of efficiency is doing things right, which is practically what underpins the preceding meaning. Efficiency can be learned, and so also effectiveness.

Effectiveness means reaching a goal within the constraints implied by planning, which includes the financial plan, time schedule, and human resources. Quality is also a top item in this list; it is not admissible to accept any kind of low quality or compromised deliverables. Only those acts count that meet established objectives. This is underlined by the second definition of efficiency that emphasizes the importance of doing the right thing. In that sense:

- Efficiency concentrates on the means, and
- Effectiveness focuses on the result.

The reader should notice that in the general case efficiency and size do not correlate; and at worse their correlation is negative. The proof of this statement comes by way of a recent finding that the 13 biggest global investment banks are less efficient and less profitable than the next 200. The 13 investment banking groups on which a McKinsey study focused represented among themselves 54 percent of the world's market for financial products and services.

In terms of return on equity the average profitability of these top investment banks was just 8 percent in 2012, with their performance dragging down the global average to an overall 10 percent. In other terms the lower efficiency of top banks was offsetting strong results from second-tier institutions in North America, Europe, Asia, and Latin America.

A major negative influence on return on investment has been the banks' failure to cut costs quickly. This added to the fact that banks "too big to fail" were forced by regulators to up capital levels more dramatically than smaller institutions. "For larger institutions, cost-reduction efforts have thus far failed to keep pace with revenue declines," the McKinsey report said. "Among the top 13 banks revenues have fallen 10 percent per year since 2009 while costs have dropped just 1 percent per year."[13]

The same consultancy report also criticized the banks' poor record in simplifying large, complex product ranges, as well as their failure to embrace quickly structures that could allow costs to be cut faster and more easily. At the high-water mark of recent years, investment banks generated aggregate revenues of $465 billion in 2007 and $473 billion in 2009 versus $331 billion in 2013 and a projected $330 billion to $400 billion for 2017. In other terms the effectiveness of their marketing effort has fallen and this has not been compensated by a sharp cost control.

As the examples in the preceding paragraphs demonstrate, management's effectiveness is a measure of its ability to produce a desired result. But while in ancient Greece this concept was the cornerstone of *arête*, today the sciences use the word "effective" in different ways. In physics an effective theory helps in explaining observed phenomena without claiming that it properly models the underlying processes. In medicine, effectiveness relates to how well a treatment works in practice as contrasted to treatments doomed to failure.

What particularly interests us in this book is effectiveness in management, and that means deliverables. An out-of-the-box idea practiced by some companies is to improve effectiveness by being transparent in failures and learning from them. P&G encourages its employees to talk about their failures as well as their successes during performance reviews. Eli Lilly, the pharmaceuticals firm, and Intuit, the software company, hold *failure parties*. Tata, the Indian conglomerate, awards an annual prize for the best failed idea.[14]

One way to judge management's effectiveness is to measure how the market votes for it with dollars, pounds, or euros. Nokia, the Finnish former market leader in mobile phones,has been struggling with the transition to smart phones and other devices enhanced with artificial intelligence. In 2011 its share price fell to its lowest level in 13 years after the company issued a profit warning, and, with results continuing to be below expectations, in 2013 Nokia sold its mobile phone operations to Microsoft.

On the contrary, according to an annual survey conducted by Harris Interactive, a much more effective Amazon rose to become the most reputed company in America. In February 2013 the online retailer overtook Apple to the No. 1 slot. Walt Disney, Google, and Johnson & Johnson completed the list of top five.[15]

If the term "effectiveness" changes its meaning according to the area where it is being applied, efficiency is also given different interpretations in the sciences and in business life. In thermodynamics, in terms of energy conversion, efficiency of heat engines measures the heat loss (second law of thermodynamics). The target is thermal efficiency, taken as equal to the ratio of work done to thermal energy consumed. Other terms in everyday use are radiation efficiency, volumetric efficiency, and quantum efficiency.

In economics and finance we talk of economic efficiency, market efficiency, capital allocation efficiency, wages efficiency, and business efficiency. Statistical efficiency provides a measure of accuracy of an estimator. Material efficiency compares material requirements, for instance, those of a physical process, construction project, or other enterprise. But while efficiency is indeed a popular term, its usage is not always justified by obtained results.

Unless efficiency is built into a product at the drawing-board stage, its manufacturing and its usage will be untidy and costly. An example is provided by the remotely piloted Reaper MQ-9 aircraft, known as the Unmanned Aerial Vehicle (UAV) or Unmanned Aerial System (UAS). Laden with sophisticated sensors, and carrying Hellfire missiles and laser-guided bombs, it has been patrolling the skies above Afghanistan,launching lethally accurate strikes against the Taliban.

There is not a man in the cockpit, but each Reaper requires more than 180 people to keep it flying. A pilot is always at the controls though he may be located in a base that might be 10,000 kilometers away, while other officers operate its sensors and cameras. The large group of people manning a UAS increases the cost of the weapon sharply, which counts a lot as there are now more hours flown by US remotely piloted aircraft than by manned strike aircraft, and more pilots are being trained to fly serial unmanned vehicles than manned military aircraft.

To be successful, some processes and projects require both high efficiency and great effectiveness. A typical example is risk control. In 2013, Calpers, the huge California pension fund, documented the $260 billion investment outlines by way of a set of guiding principles projected to form the basis of all future investment strategy decisions. An integral part of the list is a commitment to "take risk only when we have a strong belief we will be rewarded for it."[16]

Some management decisions and the acts that follow them are short of both efficiency and effectiveness. A basket case is Obamacare, the so-called Affordable Care Act (ACA). There ought to have been more inquiry, more scepticism, and better planning about whether it could be universally available, high quality, and low cost, all at the same time. Instead, there have been improvisations and snafus.

Since its October 2013 introduction ACA has been a total mess while Obama was making rash promises. In mid-November 2013 he told Americans who had lost their existing health insurance policies that they could retrieve them if they liked them. But he simply forgot to check with the 50 state regulators who administer the law, and with the insurance companies, which were expected to do the take up.

In the aftermath the Democratic Party suffered political damage from the botched implementation of Obamacare, as the administration could not convince Americans that they have the program under control and have positioned themselves for going forward. Both efficiency and effectiveness were absent from the planning and rollout of an unaffordable healthcare act and the negative results became evident at no time.

4. Barclays Stars Scam

Efficiency has many aspects and effects. One of the aspects is that the most important asset of a bank is not the money in its vaults. It is its people: its clients and its employees. This is true of every enterprise. During IBM's heydays 85 percent of its annual business came from its existing customer base, thanks to the fact that the company's salesmen were trained in customer handholding.

The importance of able-brained employees and satisfied clients is often forgotten by management too eager to profit from their clients to improve their bonuses (sections 5 and 6), or to get some extra income in order to cover the losses that they have suffered by gambling rather than by being the best in their line of business. This is not a revolutionary doctrine. It is simply the recognition of a long-concealed economic and social fact.

One day, in June 2011, I got a letter from Barclays bank, where I had an account. The letter stated: "A recent review of Barclays Wealth International iBank clients has shown that, although you have been able to use the iBank service, you have not been charged the usual monthly fee." iBank had a fee of £5 ($8.50 or €7.50) a month, which the letter said would be applied to my account from September 5, 2011. The letter was signed by Anne Grim, managing director, Barclays Wealth International, and it concluded by stating:

> "You do not need to do anything—we'll apply the monthly fee of £5 to your account unless we hear from you by 8 August 2011."

The statement that I used Barclays' iBank was incorrect. In contrast to the aforementioned IBM example, it was as well a show of inefficiency in customer handling. Without any loss of time I called Barclays to say that I never used the iBank.

The phone was answered by a Mr. Mikel who said: "I know you have not used the iBank," adding that the charge would be applied anyway. According to Barclays, the way to avoid it would have been to upgrade to their Relationship Manager Service, which is available to clients who have a balance of at least £50,000—of course without paying any interest.

If there is a sure way to make an enemy out of your client, it is by taking him to be stupid. Hence I sent a registered letter to Anne Grim: "Ref: Your Pseudo-Individual Correspondence of June 2011, which states that a recent review of Barclays iBank clients has shown that, although 'I have been able to use the iBank service . . .'" repeating that I have never, ever used Barclays iBank service. Her colleague had admitted that much.

My registered letter brought to her attention that the lie about clients using iBank, while they don't, was written and signed by her— to justify charging a fee that, given the competition for banking services in Britain, may make them lose clients. Neither did I fail to point out that such a letter told everything about her bank's business ethics. As expected, she did not bother to answer and my next step was to close down the account severing any further relation with Barclays.

Of course, Barclays is by no means the only bank to try to get the maximum out of its customers by way of trickery. Some years ago the wealth management department of a major Italian bank increased its annual fees by 30 percent—just like that, without informing its customers in advance. When I called to complain, the account manager said: "Don't worry. I will reinstate the old fee." He then added, "Typically only 5 percent of the customers complain on fee increases. The other 95 percent don't and the higher fee stays." Great ethics.

The end result of breaking with *areté* in this case is that trust in the bank and its bankers melts like snow in the sun. Since the 1990s, when banks started to play win or lose with derivative instruments, they desperately looked into unethical ways to increase their income from steady customers and cover part of the losses from gambling. Malpractices did not end there, because after violating their customers' trust they also broke the letter of the law and this had severe consequences.

Barclays' Libor scam, for example (chapter 7), not only prompted criminal investigation by the British Fraud Office but also meant hefty penalties by bank supervision authorities in Britain, America, and the European Union. Adding to Barclays' unconceivable unethical practices there is as well its record on the infamous *Stars* deal of tax arbitrage. This was developed in the boom years by an in-house group led by Roger Jenkins and Iain Abrahams.[17]

Stars, which was sold to institutions, including the Bank of New York (BNY, now New York Mellon), was a "scientific" tax evasion scam that went as follows. The Bank of New York set up a trust in Delaware and invested, say, $10 billion of shares and assets. Barclays contributed $1.8 billion in exchange for shares that gave it rights to most of the trust income, which had to be reinvested in the trust. This $1.8 billion was then loaned to BNY for ordinary business use.

The next step in the *Stars* tax cheat was that BNY appointed a British subsidiary, which paid tax in Britain, to be trustee. Subsequently, that money was claimed as a foreign tax credit. Barclays paid some tax, but also got a tax deduction for reinvesting trust income. Further on, the two parties executed an agreement giving BNY access to the $1.8 billion at 3.1 percent less than prevailing market rates. After five years, the deal ended and each party got its money back:

- $10 billion to BNY, and
- $1.8 billion to Barclays.

At the core of the scam and tax evasion were differences between how the tax systems work in Britain and in America. Under British rules, Barclays was allowed to take a deduction against its other taxable income (in Britain) on the condition that it immediately reinvested all income produced by the assets in the trust. Simultaneously, it took a credit for the tax paid by the trust.

The loss of income tax did not please the American authorities. The Internal Revenue Service (IRS) in the US, which prosecuted the tax arbitrage, claimed that the tax benefits were shared by BNY and Barclays. For every $100 of income circulated through the trust, the US government lost $18.15, BNY had a profit of $7.15, Barclays had a profit of $7.70, and the British taxmen receipts of $3.30.

BNY also got foreign tax credit for British taxes paid. "The foreign tax credits that Bank of New York claimed in the US at a 22 percent rate were far more than the actual UK tax attributable to Stars," said the IRS. "In other words, Bank of New York claimed credits for phantom UK tax expense."[18] Moreover, by lending to BNY through the structure that Barclays designed, the British bank could offer a very favorable borrowing rate.

In banking terms this tax arbitrage has been part of the business known as *structured capital markets*, and went on for at least three years. Tax avoidance strategies have been ethically controversial, and the taxmen struck. Barclays' "tax avoidance" product line came under the spotlight twice in 2012, first over the use of the tax loophole that the US

Treasury closed retrospectively, then over a tax equalization payment of about £6 million ($9.6 million) to the bank's chief executive, Bob Diamond.[19]

By September 2012 Barclays announced that it would take the axe to its tax structuring unit as it sought to clean up its image after the scandal. According to some estimates, however, in the meantime *Stars* generated up to 75 percent of profits at the investment banking operation with its classic tradition of curious new instruments. In the end, the scam hurt the bank's reputation as it:

- Drew political attention, and
- Gave rise to negative media coverage.

In an attempt to recover at least some of its creditworthiness, Barclays also let it be known that it planned a withdrawal from selling derivatives products to consumers and small-business customers. This came in the aftermath of another industry-wide scandal over the mis-selling of interest rate hedging contracts that had for some time provided a stream of profits, while as an early bird in the summer of 2012 Barclays was fined £290 million ($464 million) by global regulators over the attempted rigging of Libor benchmark borrowing rates. That triggered the resignation of Marcus Agius, Barclays' chairman, and Bob Diamond. The underlying idea was that of discovering new forms of steady earnings, but the absence of ethics and ineffectiveness took their toll.

5. "Say-on-Pay"

Excessive pay for managers angers shareholders who are, increasingly, vetoing it. Say-on-pay rules, which allow shareholders a vote on pay-and-perk packages, are spreading across continental Europe. Germany introduced a say-on-pay recommendation in 2009. By 2010 most German firms gave shareholders a vote.

A north-south divide, however, persists as most southern European firms don't want investors to question managers' pay. Disclosure, at least, has improved almost everywhere. In the early years of this century, hardly a third of European firms properly disclosed pay packages for senior executives; now about 60 percent do so.

The stakeholders' reaction to year-on-year significant increase in senior executive pay and bonuses does not mean that all of them are rejected outright. Compensation packages still pass through. On April 22, 2014, big shareholders backed Citigroup's senior executives at the bank's annual meeting in St. Louis, with 84.6 percent voting in favor of the executive pay plans.

The support provided some relief to the financial institution that had failed to gain a majority in the same vote two years earlier. Curiously enough, the change in shareholder mood came a week after the Federal Reserve blocked Citigroup's plans to increase capital returns to equity holders in 2014.[20] Executive pay and bonuses reserve surprises because they hold a special position in the realm of decisions management makes.

The traditional pillars of free enterprise have been valued employees producing the best products for satisfied customers. Over the last three decades, however, this has been replaced by maximum bonuses to management and a mousetrap for investors. Some of the values of the past that produced great enterprises—loyalty, fairness, quality of produce, attention to detail, handholding of clients, service to the community—disappeared from the screen in the whirlwind of getting rich quickly. It's indeed a pity to watch the spoilage of human assets at a time when:

- Knowledge,
- Experience, and
- A steady customer base are in short supply.

Only enlightened spirits see the importance of knowledge, skill, and experience as well as their contribution to development. Deng Xiaoping, China's paramount leader in the early 1990s, realized that the country could accelerate its development by learning from Western experts rather than by feeling its way by trial and error. This helped China's (then) new generation of leaders, who followed Deng in power, in reorienting growth:

- From labor-intensive manufactured exports,
- To capital-intensive products and services.

There is little doubt that successful managers must be compensated for their contribution. The problem is that in the West today pay and bonuses have no relation to performance. CEOs and other professionals shower themselves with lots of money whether they are efficient or inefficient, effective or ineffective in the work that they do—and there is plenty of ineffectiveness to talk about.

Ill-conceived ventures link together raids on client properties and territorial conquest in the globalized economy. But investors have enough of being taken to the cleaners. In early April 2013, the $255 billion Calpers announced that it will take on “zombie” directors and rogue pay arrangements. It also stated that it had identified 52 directors who had failed to win shareholder votes but either stayed in place or were subsequently reinstated.[21]

Calpers’ announcement added to pressures on the Securities and Exchange Commission (SEC) to revisit the so-called proxy access rules intended to make it easier for shareholders to eject board members; these rules were thrown out by a federal appeals court in 2011. The SEC initiative came after Calpers has secured notable successes, in the early months of 2013, including helping Apple to obtain support for the introduction of majority voting in boardroom elections. It was also successful in discussions to shake up the board of Hewlett-Packard.

CEOs and their rubber-stamp boards have become a conquering power. To the detriment of the owners (the shareholders), CEOs have managed to arrange extravagant bonuses for themselves, their senior executives, go-go traders, and investment bankers. Typically, they all earn a stream of great bonuses when the years are good, and when there are losses they are not asked to disburse anything. They just blame:

- Nervous markets,
- A systemic crisis, and
- Unexpected events for results demoralizing shareholders.

Yet it is no less true that if companies continue to engage in trades that explode after a period of steady gains and do not disgorge previous undue compensations, ethics wane and personal accountability takes leave. Even worse is to allow the insiders get most of the profits while the losses are supported by shareholders and taxpayers. That’s a vicious cycle.

What a totally asymmetric approach to risk and return demonstrates is that the incentive system put in place by all sorts of companies, particularly financial ones, has produced a vulnerable economic system that works in reverse. The “incentives” supposedly paid for performance, have become disincentives to prudent management—and many firms are brought to ruin because of the lust of the very few, a situation the relatively new “say-on-pay” concept aims to correct.

On the strength of “say-on-pay” rules that allow shareholders to get involved in pay and bonus decisions involving professional managers, in mid-April 2012, equity owners in Citigroup voted against planned compensation packages for Vikram Pandit, the bank’s chief executive, and members of the board of directors. It was the first time something like that happened at a big American bank since the rule was introduced under the Dodd-Frank reforms.

Around “say-on-pay” may eventually grow a new compensation system for business. While the shareholder vote at Citi was nonbinding, it underscored the anger felt by some investors at the perceived uncoupling of pay from efficiency and effectiveness. The big bank’s earnings had failed to excite the markets and its most recent dividend to shareholders prior to that “say-on-pay” vote was a mere one cent.

Just a month later, on May 8, 2012, Andrew Moss bowed to investor pressure and stepped down as chief executive of Aviva, the British insurance company, after holding the position for almost five years. His departure came after he lost a shareholder vote over the insurer’s executive pay report, but he still received a severance package of about £1.75 million ($2.8 million)—the so-called golden parachute.

In the case of Aviva, investors said they had used the vote to signal displeasure about the group’s leadership and share price underperformance. Moss was the third high-profile British chief executive to fall following investor anger over executive pay,[22] and many institutional investors welcomed his departure. One of the company’s equity owners said: “The relentless destruction in shareholder value has eventually resulted in his exit.”[23]

The message conveyed by these examples is that the owners are revolting against industry salaries and bonuses that have taken a one-way street: up. In one year, 2013, the average cash bonus paid to Wall Street employees jumped 9 percent following rebounding financial industry profits. New York’s financial sector had recovered and was reporting collective profits—but 83.7 percent of these collective profits went to cash payments that totaled $20 billion in the 2013 bonus season (reflecting work undertaken in 2012).

The irony is that many bankers considered business and profits in 2011 and 2012 as having been rather subdued, yet in 2011 US executive compensation alone rose by over 20 percent, for no other reason than that the gatekeepers were serving themselves with shareholders’ money (see also section 6). According to an article in *The Economist*: “The financial crisis revealed that top bankers were fabulously remunerated for doing what turned out to be a lousy job. Some pocketed immense bonuses when they falsely appeared to be doing well, and then kept much of the loot when their firms collapsed.”[24]

The magazine quoted Warren E. Buffett who said: “If a bank had to go to the government for help, the CEO and his wife should forfeit all their net worth.”[25] Buffett is right. Pay and bonuses unrelated to efficiency and effectiveness have prompted investors to rebel at several big company annual meetings—not only Aviva and Citigroup but also Barclays and Credit Suisse—as they want senior management to share the spoils between employees and shareholders more evenly.

If industry, particularly the banking industry, wants to retain the bonus system, *then* the basic culture behind it must change. Pay and bonuses have to be redimensioned and awarded for results, not just for being there. Besides that they should be longer term in retribution, based on mean performance over three, four, or five years (more on this in section 6).

Among loan officers and traders, for example, payoffs should be delayed until borrowing of funds and trade deals have established a sound payment record. In addition, traders' bonuses should be computed on the basis of end results with clawbacks for losses due to excessive risk taking. A system that pays in advance without respect to assumed exposure is unethical, ineffective, and biased to its core.

6. Obama's "Fat-Cat Bankers" and Clawbacks

"I did not run for office to be helping out a bunch of fat-cat bankers," said Barack Obama in mid-December 2009.[26] His remarks came days after France and Britain announced moves to crack down on bank bonuses, and after Jean-Claude Trichet, the then president of the European Central Bank, stepped up attacks on the expanding bonus culture.

According to critics, the system of huge bonuses encouraged some of the most risky behavior that led to the deep recession. The pros answer that financial people who make the rich lists do not run banks; instead they are hedge fund managers and dealers in distressed assets who can plunge into a river of red ink and draw out of it assets with improbable sums attached.

It is no less true, however, that just two years after the economic and financial hecatomb, which was not far from bankrupting the global banking system, British banks paid $6 billion in bonuses for 2010[27] and in 2011 the directors of Britain's 100 biggest companies saw a 49 percent rise in their global earnings, taking their average to almost £2.7 million ($ 4.3 million).

- This was way out of line with the performance of share prices, and
- It took place while the country was enduring a period of severe austerity.

In the aftereffect, popular outrage was shared by the leaders of all the main political parties, with articles and commentaries stating that the country's boardrooms were out of touch with reality and in many cases they paid "reward for failure."[28] The central element in the whole compensation system was wrong.

Not just in Britain but in a large part of the Western world public opinion hardened against what was seen as boardroom excesses. A measurement of pay discrepancy is the ratio of executive pay to average worker pay, which increased beyond bounds. In Roman times that ratio was 20 to 1, not too different than that after World War II. But that changed with the skyrocketing of salaries, which started in 1965 and kept going strong over five decades:

- In 1965 the ratio of US chief executive pay to average worker pay was 24,
- In 1075, it became 35,
- In 1990, 70,
- In 2000, nearly 300, and
- In 2010, that ratio reached 325.[29]

According to the High Pay Commission, in Britain the average FTSE 350 director saw his earnings jump by 106 percent between 2000 and 2010, aided in no small part by a 253 percent rise in their long-term incentive plans—while total shareholder return was just 33.7 percent and share prices actually fell 5.4 percent.[30] Critics said that behind the justification for such huge compensations were:

- Aggressive accounting practices,
- Excessive leverage,
- Deferrals of long-term investment,
- Strategies weakening the capital base, such as share buybacks, and
- Acquisitions that destroyed value, while increasing headline earnings per share (EPS).

EPS has indeed been used as a justification of higher salaries and bonus, even if many efficiency experts doubted the wisdom of doing so. Another measure employed for determining pay increases has been return on equity (ROE), and it might have had a worse impact than EPS. It is likely that the banks' pursuit of high ROE by using excessive leverage has deepened the economic and financial crisis that started in 2007.

These considerations lead to the likelihood that extravagant pay and bonuses may not only be unjustified and, as such, be socially unacceptable, but they may also be destructive in broader economic terms. The ways and means used to promote them put in motion macro forces that upset the established pattern of economic development bringing it to a state between overexploitation and incoherence.

What many investment banks and their employees fail to appreciate is that the negatives of excesses go well beyond public anger in regard to retributions that are way out of line when compared to deliverables. In the 2005 to 2007 timeframe Merrill Lynch paid out $45 billion; Citigroup paid $34.4 billion;[31] Lehman Brothers, $21.6 billion; and Bear Stearns, $11.3 billion. The return to shareholders has been negative.

- Lehman went bust hitting shareholders and stakeholders like a hammer, and
- Bear sold itself for peanuts to JPMorgan Chase while the little equity holders got was halved as the JPMorgan stock went south.

By January 2009 the stock market valued Citi at $18 billion, nearly half what it had shelled out. As for the Merrill Lynch's shareholders, they got shares in Bank of America, which, in January 2009, were worth just $9.6 billion, less than 20 percent of the original offer value. Moreover, the row over the early payment of 2008 bonuses at a nearly bankrupt Merrill Lynch, to the tune of $4 billion, was paid by taxpayer rescue money. This provided further evidence that while insiders' interests come first, at the end of the day there may be only losers.

- The top cats of banking pocketed most of the profits when the market was booming, and
- Shareholders as well as taxpayers bore the bulk of the losses during the bust.

The situation was akin to that of bankers awarding themselves an unprecedented license to gamble to gain huge payouts, while being too dumb to recognize the risks they were taking. The talk that they thought the economic outlook was "stable" and that "the financial system was doing a good job of spreading risk" are lame excuses for manipulating the system all the way to its destruction. It is nevertheless true that a year prior to the crisis Ben Bernanke, then Fed vice chairman, lectured Wall Street bosses that the central bank had the power to pull them out of trouble, therefore there was no need to worry.

Many blamed the distortions in the economic system on a culture characterized by an excessive drive for profits and a lack of awareness among executives and trades of their personal responsibilities. At practically all levels of the organization employees would be willing to do anything to meet sales "targets." But there exist systemic defects and, should they be left unattended, it would lead to a serious adverse impact as demonstrated by the turbulence the economy went through.

In 2008, as member of Citigroup's executive committee, Robert Rubin, the former US Treasury secretary and former head of Goldman Sachs, earned some $115 million from Citigroup for taking risks that shareholders and taxpayers paid for. No attempt has been made to clawback that money from him. Neither has any other bank managed to reclaim some past bonuses from its former executives, traders, or investment bankers (with the possible exception of UBS).

Yet *clawbacks* could be a good deterrent to pay and bonus excesses. They can help postmortem in correcting a subjective, biased, or temporal mismatch between the realization of a company's profits and its remuneration policy. It also makes sense to apply them to both regular losses and to fraud. The problem is how to implement a clawback in a consistent manner.

Will the executive or trader who has to pay back an undue bonus do so? Any organization employing more than a handful of people finds it hard to manage its incentives, and senior employees would fight back contesting clawback claims. It is much more reasonable to keep the bonuses commensurate with extra effort and performance, dispensing them not one tantum but scaled over time. This is a practice followed by consultancies, and it has given good results. Then, there is no problem of financing the clawback if one has to be applied.

In conclusion, bonuses have been the way to attract higher caliber of competent staff. It is not the bonuses as such but the excesses associated with them that brought banks to their knees and ended up needing public bailouts. Not only are extravagant pay and bonuses counterproductive but also the truth is that *if* their recipients were as competent and talented as they are supposed to be, banks would not have needed huge bailout packages in the first place.

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Senior Managers Are in the Frontline of Efficiency and Ethics

1. The Accountability of Senior Managers

After the fall of Enron, practically everyone is agreed that board members, chief executives, chief financial officers, and other senior managers must be held accountable for the financial information their company releases, including the reported profits and losses. The Sarbanes-Oxley Act, which came on the heels of Enron, WorldCom, and other debacles, specifies that there should be significant penalties on those who falsify financial reports, in addition to the punishment by the markets.

Both carrot and stick are necessary to give boards and senior managers an incentive to examine more closely their firm's financial performance, auditing results, and independence of opinion expressed by public accounting firms. Some companies today foster an environment where the independence of the external auditor is compromised though they do appreciate that it is vital to reduce harmful conflicts of interest, including the amount of non-audit services a company purchases from its accountants and auditors.

According to a growing body of opinion, not only boards and senior managers but also investors—particularly major investors—should be held accountable as stakeholders in a company. As Scott G. McNealy aptly stated in an interview dating back to the early years of this century, they don't have "to invest in a company that's going like crazy, maybe it's too good to be true… [They] ought to read the income statement, the balance sheet, and the footnotes.[1] This advice raises the following questions:

- How many investors actually read the footnotes?

- If they read the footnotes, are they able to understand them?
- If they don't understand the footnotes, why invest in something one cannot understand?

If a careful investor who exercises prudential judgment was investigating the extraordinary performance of Enron relative to the market, he would have been able at least to guess that, among industrial companies, this energy outfit was more an aberration than the norm. Indeed, it is hard to understand why nearly everyone was not more questioning of this company's spectacular rise, given the poor performance of the rest of the market.

Postmortem it has been said that the level of ethics at the vertex of management was dismal and Enron was run as its CEO's one-man show. Conformism was the most widespread attitude. Kenneth Lay, the CEO, chose the members of the top management team single-handed and allegedly every member of that team was expected to comply with his personal wishes. When Enron crashed, the members of that top team:

- Lost their jobs, salaries, savings, and pensions, and
- Some of them, like the company president and chief financial officer (CFO), landed in prison.

Lay's style of management and his ethics contrasted greatly with those prevailing in other companies, like General Motors, at least some of the time. After the end of World War II, Alfred P. Sloan Jr., GM's legendary leader and CEO, once asked at a board meeting: "Gentlemen, I take it we are all in complete agreement on the decision here."[2] When the assembled executives all nodded their assent, Sloan said:

> I propose further discussion of this matter until our next meeting to give yourself time to develop disagreement and perhaps gain some understanding of what the decision is all about.

Sloan's policy combined efficiency and ethics, but not every chief executive stands up to the board or has the guts to challenge its decisions. Some decades later, when Roger Smith was General Motors' CEO, he instituted quite a negative policy: eliminating any board member or line executive who brought up a difficult problem on which a decision had to be taken, questioned management decisions, or expressed non-mainstream views.

When such a negative managerial environment dominates, sooner rather than later the company will be doomed. GM went into bankruptcy some years down the line. Negative policies are no rare exception. With the Bush White House, too, the prevailing spirit of loyalty and consensus meant that dissent, dissonant data, or discomforting information was (reportedly) not welcome in discussions.

According to political analysts, George W. Bush Jr. bet on people's desire to be part of the top crowd by dwelling at the center of power. This played heavily against negative views or exploratory debate, ostracizing people with different points of view or (God forbid) those who disagreed with his policies. The result has been a failure to open up the Bush White House to fresh perspectives, as otherwise intelligent people can blind themselves to:

- The alternatives, and
- The consequences of their decisions.

In her book *Willful Blindness* Margaret Heffernan explains some of the tensions involved in bringing together ethical values and efficiency. One of the underlying factors is the indifference on the part of some people in putting forward their goals or in trying to implement decisions reached by others. According to Heffernan, *if* some efficiency goals are objectionable, *then* they should not be adopted.[3]

Heffernan takes as example the role Paul Moore was assigned at the Halifax Bank of Scotland (HBOS). Moore chaired the Regulatory Risks Group. In the opinion of its employees, the bank never hit its sales targets ethically. There was so much pressure to reach targets that it led to a culture of bullying, focused on sales numbers.

Moore's job was to look at all aspects of the company's processes and procedures as well as as its balance sheet. But the greatest exposure didn't lie in the numbers. It lay in the people and their incentives. When he shared his insights with the CEO, Moore was fired. He was vindicated when, in September 2008, the bank collapsed.

The focal point of criticism of this management nearsightedness is that people are not only blinded by power and money but they are also blinded by pride: "Moi president,"[4] as François Hollande, the French president, says. Conflicts of interest, too, play a major role in such nearsightedness. Take longer vacations and much higher pay for the same work as an example. Two referendums in Switzerland converge at the same point. Sponsored by labor unions and the socialist party:

- The first referendum put to vote a fourth week of vacations, and it was defeated.

- Both the majority of the citizens and the majority of the cantons voted against that proposition not because individually the citizen would not have liked more vacations, but because they understood that this would increase the cost of work, make Swiss products uncompetitive in the global market, and, by consequence, increase unemployment.
- The theme of the second referendum, held in mid-May 2014, was to institute a minimum monthly salary of Swiss francs 4,000 and an hourly minimum wage of Swiss francs 22.

For the same reasons, 66.5 percent of the Swiss, or one out of two persons, voted against this second proposition. More manna from heaven for the same job is the hidden side of *moral hazard*, a term used to describe a process whereby risk takers are shielded from the way of public money.

Apart the ethical considerations associated with moral hazard, a direct result is that it leads people to take great risks, encouraging even more reckless behavior. These two Swiss referendums have demonstrated that community intelligence has been vastly superior to ill-directed political (socialist) and labor action. The so-called leaders failed in their duties. But the Swiss people stood firm.

2. Personality Traits Characteristic of Sound Management

The most common qualifications necessary for senior management—as well as for membership of the board of directors—are the ability to preserve and protect the company's assets as well as to collaborate with people in reaching common goals. After all, the most precious assets of a firm, of any firm, are two: its clients and its employees.

Specific skills, too, are needed, even if in many cases the requirement of professional expertise in "this" or "that" domain is not clearly spelled out. On-the-job performance is generally interpreted as the ability of company executives to bring to fruition a variety of experiences gained from "other organizations" active in similar or complementary walks of industrial and business life.

This brings up the issue of "generalists" and "specialists" in professional duties including management functions. Though some management theorists maintain that expertise in a given industry is not critical at the CEO level, statistics and experience demonstrate that it is indeed most crucial. Therefore, it is regrettable that most organizations don't take care to describe, much less define, what makes a good director or line manager.

In my book, the crucial question is: What should *our* organization expect from people qualified for board membership? In a world characterized by steady and often profound changes, general traits can be misleading, but we can always establish one common denominator centered around the ability to examine the critical factors that affect organizational survival, including the skill to forecast and introduce *change*.

The effectiveness of implementing change depends on personal qualifications for which no theoretical models can be developed, nor can currently available instruments be used effectively as substitutes for the tough decisions that are needed. Quality management takes time to develop and failure to maintain quality leads to a decline in management standardsexercise it leads to its decay. No skill that is acquired overnight, for instance, through an intensive training program, lasts for long. A short life also characterizes:

- Ethical behavior, and
- Management productivity.

Productivity on the manufacturing floor and productivity at the general management level are two different concepts; they should not be confused with one another. In a factory, productivity is the amount of output produced per unit of input. This is relatively easy to define. On the contrary, at the general management level productivity is difficult to gauge because management output tends to defy precise measurement.

In a modern economy, management output includes product innovation, quality of produce, customization, time to market, and other intangibles. These must be coordinated efficiently to improve the value of the deliverables to customers and enhance a company's appeal to the market.

Productivity measures are biased when management fails to appreciate that technology is only one component of the overall investment. There are other expenditures like lifelong learning, organizational changes, process redesign, machine investments, software development, and so on. While computers might contribute to increased output, the rate of return on technology investments is not linear.

This concept of return on investment must be part and parcel of the education of all professionals, which is not happening today. In the course of the last three decades, America has been developing a distinctly European disease: structural unemployment fed by a wrong-way educational policy. Youth unemployment is especially high, and on the increase.

One, but only one, of the reasons for the increase in unemployment is the elimination of many mid-level jobs and of the professional knowhow that goes with it. Both Europe and America had employment problems prior to the severe economic crisis and great recession that started in 2007, particularly for less-skilled men. The new problems connected to semiskilled jobs are caused not only by sweeping changes in technology and by globalization's effects, which are present in all countries, but also by the redefinition of the very nature of professional knowhow. In the US, the absence of employment opportunities hit the following groups harder:

- 25 percent of men aged 25–54 with no college degree,
- 35 percent of white high school dropouts, and
- 70 percent of black high school dropouts.

As in Europe, this is a case of entrenched joblessness requiring painful decisions by both the young generation and the state's educational system. It also calls for farsighted measures to bend the curve. At a May 2010 forum at the University of Milwaukee-Wisconsin, Joe Biden, the American vice president, aptly said to the audience: "The only place where success comes before work is in the dictionary."[5]

Management productivity is not improved by way of manipulating prices, or by other illegal acts that violate the principles of ethical behavior. The arm of the law may take some time to move, but when it does the results are disastrous to the firm. In May 2011, the US Commodity Futures Trading Commission (CFTC) charged an oil trading firm, two of its affiliates, and two traders with attempting to manipulate oil prices in 2008. The regulator alleged that the defendants:

- Purchased substantial positions in the physical market for West Texas Intermediate (WTI) oil to give the impression of a shortage, and
- Simultaneously bought oil futures to profit from the subsequent rise in prices.[6]

This is part of a vast area of exposure known as *operational* risk.[7] Senior management itself may be part of it. Just one month, June 2002, saw the indictment of three CEOs. At Rite Aid, former CEO Martin Grass and two other former officials were indicted on fraud charges; at ImClone Systems, former CEO Dr. Sam Waksal was charged with inside trading (see also in chapter 1 and the case of SAC Capital); and at National Westminster Bank, three former bankers were charged with defrauding the bank through secret investments in partnership with Enron.[8]

If you think that the answer to such scams is more independent directors, think twice. As Enron, Global Crossing, WorldCom, and so many other cases have shown, all too often "independent directors" are not really independent. Several outsider directors have banking or other connections, or simply end up having ties with the CEO. "On the surface Enron's board looked independent," said Jay Lorsch of Harvard Business School. "But everybody on that board was selected by Ken Lay."[9]

The problem that immediately presents itself in those cases is that when the CEO dominates, the rest of the board forgets all about questioning his leadership. Not just in a couple of cases but in many board meetings there is no critique of the chief executive's policies and acts, and this constitutes a major operational risk.

No wonder that several regulators want to change all that cozy relationship, insisting that a majority of directors would have to be truly independent. Real outsiders means no ex-employees of less than five years or anyone whose livelihood, in some way, depends on the company. In addition, outsiders will have to meet regularly without the line management being present. But will this have the wanted impact? Would it not be better to criticize a CEO to his face rather than behind his back?

Will a board of independent directors be better positioned to lead the company into reinventing itself and its products, becoming a leader in innovation? Innovation happens in the market as it happens in the laboratory. The personalities of senior executives and of members of the board, their knowledge, information, drives, decision styles, and, at the bottom line, the strategies and tactics they choose, make the corporate structure and culture. In turn, these affect the life cycle of an organization.

3. High-Quality People

In their early stages organizations are often originated by thinkers. In the Standard Oil empire, John D. Rockefeller Sr., its developer and animator, was a thinker. He conceived the idea of commercializing oil, moving from wholesale to retail, and by doing so he created a market that never existed before—and what a market!

During the growth phase of Standard Oil, however, and most particularly the years of consolidation that followed as the oil industry reached maturity, organizational skills became most important. Without them, the company would have fallen apart. Knowhow in organization and structure was provided by John Rockefeller Jr., who led the company into its maturity phase, establishing it as a mighty global corporation.

As this and plenty of other examples confirm, high-quality people are crucial to the growth and survival of a firm. Together with analytical skills and decision-making styles, a basic characteristic of professionals and managers should be the ability to be in charge as well as be familiar with the needs of their times. Computer literacy is an example of the latter; another example is the willingness to keep oneself and one's knowledge base in steady evolution by:

- Remaining active,
- Being involved, and
- Paying attention to detail.

Ours is an age characterized by technological progress and market dynamics. Every company, from the simplest to the most sophisticated, lives and operates in an environment of steady evolution. No management team and no board can be successfully in charge of its company's business if its members:

- Permit themselves to get obsolete, or
- Distance themselves from active duty.

There are two kinds of people we come across in our daily lives: Those like Warburg who demand a lot of themselves, and others, the large majority, who are satisfied with themselves. The first are those who contribute to progress, who faces great challenges and win. In Warburg's opinion, the worst that can happen to any organization is auto-satisfaction, because it leads to negligence and lack of interest in what one does.

Unfortunately, this is not being taught in schools or within families. On June 3, 2014, there was a very interesting interview on *Bloomberg News* between Lloyd C. Blankfein, the CEO of Goldman Sachs, and Michael Bloomberg. The subject of discussion was young hires, particularly college graduates looking for a job, who add to their CV that "they would not accept employment requiring stress or overtime."

Michael Bloomberg aptly pointed out that these people are not employable. To be successful, a young person has to work hard, whether he works for Goldman Sachs or for the corner drugstore. Society depends on this contribution. Moreover, to succeed in life, a young person has to demonstrate what he can do rather than start by imposing unacceptable conditions on the potential employer.

Work provides personal satisfaction. No matter what its reasons may be, unemployment leads to suffocation. Along with productive work, the freedom of thought and the right to challenge "mainstream" thinking count a great deal. Their suppression is typical in a regime where socialism and communism hold sway. This is explained beautifully in a letter Pyotr Kapitsa, the Russian physicist, wrote to the then KGB chairman Yuri Andropov on November 11, 1980. This letter stated that:

> Ever since the time of Socrates, active hostility to heretics has been commonplace in the history of culture...
>
> The source of human creativity is dissatisfaction with the existing state of affairs... Of course, dissatisfaction is not sufficient in and of itself. Talent is also necessary. Since only rare individuals command the talent required to express dissatisfaction in a creative way, we ought to cherish and take good care of the few who do...
>
> In order to win horse races, thoroughbreds are needed. But there are only few champions, and they are usually temperamental. An ordinary horse will give you easier, smoother ride, but you wouldn't win any races.[10]

Competition strengthens efficiency. Nepotism kills it. Siegmund Warburg's selection of assistants was primarily outside his family's clan. As he put it to Jacob Rothschild: I, who had grown up in a very closely knit family circle, have gradually and increasingly come to the conclusion that the desirable relationships are what Goethe called *Wahlverwandtschaften*, the selected relationships in contradiction to blood relationships.[11] There were good reasons why Siegmund Warburg never ceased being interested in the recruitment and development of young talent, identifying potential stars by means of literary quizzes and the ability to manage relations with corporate clients.

While asset management became a highly profitable part of his operation and although Warburg was also one of the architects of the Eurobond market, corporate finance was his first choice. The way he put it, one fee that his firm earned from giving good service to one of its large industrial clients can far exceed what it earns in a whole year in connection with Eurobond issues. In his judgment, the important elements of a first-class private banking business were:

- Moral standing
- Reputation for efficiency
- High quality brain work
- Connections
- Capital funds
- Personnel and organization

Warburg was suspicious of firms that grew quickly, believing that there were diseconomies of scale in the banking industry. He worried a lot about the dangers of what he called expansion euphoria. The irony is that after he died in 1982, his bank embarked on ill-judged expansions while becoming complacent in its core business. In 1995 the firm that had advised on so many cutting-edge takeovers fell itself prey to Swiss Bank Corporation, for a fraction of what it would have fetched a few years earlier.

Amadeo Peter Giannini was another of the great managers and innovators of the past generations. Most bankers today take for granted the things Giannini pioneered, like home mortgages, auto loans, and other installment credit. He was also the architect of what in the late 1990s became nationwide banking, even if parochial interests prevented him from realizing it during his lifetime.

One of Amadeo Giannini's guiding principles was that there is money to make lending to the little fellow. He promoted deposits and loans by ringing doorbells and buttonholing people on the street, painstakingly explaining what a bank does. (It should be remembered that at the time it was considered unethical to solicit banking business.) Giannini also made a career out of lending to out-of-favor industries. He helped the California wine industry get started, then bankrolled Hollywood at a time when the movie industry was far from being proven.

Ginanini's vision has been playing out on a national scale for the past 30 years. The basic idea has been that a bank doing business in different industries and in all parts of a state, or nation, would be less vulnerable to any one industry's or region's difficulties. Therefore, it would be strong enough to lend to troubled communities when they were most in need, a model widely applied today in international banking.

Indeed, the first bank in the US to have branches coast to coast is Bank of America, which accomplished the feat through its $48 billion merger with NationsBank of Charlotte, North Carolina. Forty years earlier, in 1958, Bank of America had pioneering BankAmericard (now Visa), the first widely used, and fairly successful, credit card.

In conclusion, the most important characteristic shared by Warburg and Giannini has been leadership. They both appreciated that a true leader inspires his people with a mission, training them and trusting them to make their own decisions—whether in business competition or at war. Only that way can responsible executives react with the required flexibility demanded by the situations they confront. Too much sticking to the plan is dangerous when the evolution of a conflict is more or less unpredictable (as it happens in the majority of cases). The plan is nothing, Dwight Eisenhower once said; planning is everything.

4. Poor Governance

Friedrich Nietzsche has said that madness is the exception in individuals, but the rule in groups. Something similar can be stated about poor governance. The way an old joke has it, if you wish to get a job to be done, assign it to a person. If not, set up a committee. A poor manager takes six weeks to make a decision that should only take a day or two. He thus slows down operations that people are itching to move on with, while competitors leave his company behind.

Poor governance practices don't allow getting above the fray, which is necessary to win. Time and again business life has proven that the concept of fighting a thousand small battles is deadly wrong. As if this was not enough, the poor manager assumes that if he issued an order, things would get done. But it does not work that way. Napoleon has said that it is not enough to give an order. The chief executive must also ensure that it gets executed.

Another characteristic of a poor manager is that though he may realize the need for lifelong learning, he never seems to put right his training timetable. He will set up training sessions for mid-level managers that end up being cancelled because business is in disarray or the budget is too tight as it has not been properly allocated and is overrun by different departments.

The most pertinent question the board should be asking is what the firm's senior executives do all day long. A working paper by Harvard Business School shed some light on that query.[12] Researchers asked the chief executives of 94 Italian firms to have their assistants record their activities for a week. Here are the results.

The typical Italian CEO works for 48 hours a week and spends 60 percent of that time in meetings. The more diligent put in another 20 hours and the longer they work, the better the company does. A good deal of the extra time is devoted in upholding regulations that make them legally responsible for their employees' wrongdoings.

The Harvard study measured how much time CEOs spend in meetings, but not the hours they spend thinking about their company's future. Industrial history suggests that, when he was active in running Microsoft, Bill Gates took regular *think weeks*, when he would sit alone in a cabin for long hours a day, reading and contemplating. This, it is said, led to strategic decisions like the Internet tidal wave memo in 1995, which shifted Microsoft's business focus.

Gates has been rather forthcoming with his decisions and explanations, but transparency is not a universal management characteristic. According to several opinions, not necessarily documented beyond doubt, the advent of the so-called nongovernmental organizations (NGOs) has decreased the transparency and accountability at the vertex of institutions. This may be changing as donors are not satisfied with summary information. They are demanding, for instance, to know:

- What the drop in the incidence of malaria is, and
- How closely it can be correlated to the use of pharma.

It is only normal that funders are increasingly demanding proof of outcome. The demand for outcome-driven results is not going to slacken as NGOs are confronted by rapid shifts in the sponsors landscape, including the need for leaders who are well versed in change management and are capable of working in demanding environments.

It needs no explaining that lack of transparency and of personal accountability are signs of poor governance, which come as a tidal wave even if managers do not necessarily intend to do one big, bad deed. Instead, adversities develop through many small steps along the way that there is never a moment when it is simple and easy to say "no!"

Some executives attract scams and penalties like a magnet. Peter Gleick[13] is a water scientist, proponent of action on environmental changes, and winner of the 2003 MacArthur Foundation *genius award*. On February 21, 2011, he admitted having tricked a think tank, which challenges mainstream climate science, into sending him a batch of its confidential fundraising and strategy papers that he leaked anonymously to journalists.[14]

The excuse Gleick provided was that of a serious lapse of his professional judgment and ethics, which led him to deceive the Chicago-based Heartland Institute. The research papers he received were published by DeSmogBlog website, prompting a sharp reaction by the Heartland Institute. Gleick stated that he had made no changes or alterations of any kind to any of the Heartland Institute documents. But Joseph Bast, Heartland Institute's president, insisted that one paper, covering the think tank's projected strategies:

- Was a fake, and
- Its publication caused major and permanent damage to the reputation of the institute and of many of its scientists.

In other cases, a payback is attracted by way of *rent-seeking*: what economists and sociologists regard as a type of money-making based on political connections. (According to an article in *The Economist*, rent-seeking is grabbing a bigger slice of the pie rather than making the pie bigger. An "economic rent" is the difference between what people are paid and what they would have paid for their labor, capital, and or other inputs.[15])

There are, as well, other forms of poor governance, some of them having to do with scams. One of the better-known examples is the Olympus scandal. In 2008 Olympus bought Gyrus, a maker of medical devices, for $2.2 billion, and paid an advisory fee of $687 million to a firm incorporated in the Cayman Islands as well as to another firm in New York. Theoretically, the owners of these firms are "unknown." Olympus also cashed out $773 million to acquire three small, loss-making firms in businesses unrelated to its own. Japanese, British, and American authorities have been investigating the scandal.

The new president, an Olympus veteran, defended the company's payments in the Gyrus deal as well as the other acquisitions. But when asked for specifics, he said he could not comment until Olympus concluded a third-party investigation on the matter, which had yet to begin. When asked whether any of Olympus's financial advisers had ties to "anti-social forces" (a euphemism for the Japanese mafia), the new CEO replied: "I don't acknowledge that at all." But the former president, who had remained an Olympus director, stated: "There are questions that still need answering. What happened to the money, and to whom was it paid, and why?"[16]

In France, there has been the case of Alcatel, the well-known telecommunications manufacturer, which allegedly paid politicians to secure contracts in Costa Rica—where prosecutors have been combing through bank records to establish evidence. According to the prosecutors, these records indicated that over a few years Alcatel made as much as $15 million in illicit payments to top politicians and bureaucrats.[17]

In late October 2004 Costa Rica's former president Miguel Angel Rodriguez, once heralded as central America's peacemaker, was jailed on charges that in 2001 he took bribes from Alcatel in exchange for awarding telephone contracts to the company, a charge that he denied. Another ex-president, José-Maria Figueres, had admitted to taking $900,000 in "consulting fees" from Alcatel from 2000 to 2003.

Edgar Valverde, the former head of Alcatel's Costa Rican operations, was put in preventive custody, charged for corrupt acts and criminal conspiracy. Costa Rican authorities also investigated whether Alcatel violated a ban on foreign contributions to political campaigns, including that of the then president Abel Pacheco (in 2004).

As it happens so often in these cases, the company was quick in distancing itself from the scam. Alcatel argued that senior management in Paris first learned of the situation through reports in the Costa Rican press, in September 2004. The market, however, was not convinced, asking how could the top brass of Alcatel not know that $15 million had been taken from corporate accounts.

All this came at an awkward time for the French telecom manufacturer and other firms following a policy of bribes, as new anti-bribery laws held companies accountable for indirect payments even if there was no proof that top management had authorized them. In October 2004, Norway's Statoil paid a $3 million fine to settle criminal charges that it had acted improperly to secure contracts in Iran. The oil company agreed to the fine without admitting or denying the charges—but it acknowledged internal ethics rules were breached.

Antibribery laws are a powerful weapon available to investigators; but there are also others. Stricter reporting rules on international funds transfers are needed to deter organized crime and terrorism, by making it easier to trace the flow of illicit funds. As an article in *Business Week* had it, the case involving Total, the French oil company, was opened in 2002 by magistrate Philippe Courroye after Tracfin, the French anti-money–laundering unit, noticed money being transferred from a Total subsidiary to another company, Teliac.

In April 2012 in the US, Walmart, the retail empire, saw $17 billion wiped off its stock market value after an article was published in the *New York Times* alleging that six years earlier the company had learned that its affiliate in Mexico was indeed paying bribes to secure building permits, but top management had not pursued a thorough investigation.

The retailer stated that it had taken "concrete actions" to look into the matter and had created a new office in the company tasked with complying with the Foreign Corrupt Practices Act (FCPA), America's antibribery law. In a statement after the article appeared, Walmart said: "If these allegations are true, it is not a reflection of who we are or what we stand for."[18]

All cases presented in this section share disrespect for ethical values. Interestingly enough the outcomes of these cases not only violated the law but were also inefficient due to the underlying poor governance that led to disastrous results. Until we see a consistent policy of indictments against all misbehaving parties, the beginning of the end of malpractices is still far off, though there is now evidence that something has started to change in this direction.

5. The Tools of CEO Malpractices

Since the bankruptcy of Barings, the venerable British bank, in February 1995, mighty financial institutions and other big industries have been reeling from a series of mishaps and malpractices. Some of these have been outlined in section 4. Whether directly or indirectly, critics suggest that the background factors have been promoted by two reasons:

- The unchecked power of corporate executives, and
- Their indifference to rights of stakeholders: employees, shareholders, bondholders, and customers.

Shareholder activism has seen to it that corporate practices have come under the microscope. An example is the case of the Swiss-Swedish engineering company that secretly granted former chairman and CEO Percy Barnevik an \$89 million golden handshake. There is some wind of change. In Germany, a series of corporate collapses, like the implosion of the Kirch media empire, led to a shaking up of outdated German corporate practices.

Another example of malfunctioning is provided by Spain's investigation into evidence of secret offshore accounts worth \$200 million at Banco Bilbao Vizcaya Argentaria (BBVA). On April 9, 2002, top criminal judge Baltasar Garzon took over the probe into alleged secret pension funds and illicit political contributions in Latin America. In the United States top management scandals have included the granting of an unsecured \$366 million loan by MCI Worldcom to Bernard Ebbers, its CEO.

Shareholder activism is right, but it is not the total solution. Not only shareholders but also all other stakeholders tend to be complacent and mute when the stock's value, and therefore their profits, rise. Neither do the board and its audit committee always exercise their power for good governance. In many cases, the board is a rubber stamp or too involved in the company's business to keep a watch on malpractices.

Creative accounting has taken upon itself the mission to hide the fact that corporate profits have fallen. Profits are also raised artificially to justify huge bonuses by reporting eye-catching financial results. While these "results" are quite often smoke and mirrors, they do help the CEO's reputation in the shorter term.

In a widely practiced game of manipulated financial statements, the sign of distinction of some companies is that they continue gambling till they crash. For instance, Enron played the game the big way, by means of about 3,000 partnerships, affiliates, and off-balance sheet operations based on cooked books and on deception, which made a mockery of:

- Corporate ethics, and
- Financial statements' transparency.

During the go-go 1990s, responsibilities associated with corporate governance were taken lightly. Take the July 1999 collapse of South Korea's Daewoo group as an example. Its founder and chairman, Kim Woo Choong, was in hiding to avoid prosecution on fraud charges. Allegedly, he had engaged in accounting so creative that it falsely inflated the value of the conglomerate by $30 billion. (Kim Woo Chong was finally caught by the South Korean authorities.)

Not every CEO malfeasance is of such dimensions, but even much smaller manipulations of financial accounting are repulsive. In most countries they are outright violations of commercial codes *and* of business ethics—yet, they go unpunished. Owing to these malpractices, increasingly the public perception is that too many corporate executives have committed breaches of trust:

- Misinforming investors,
- Distorting the truth, and
- Enriching themselves with huge stock options, loans, and other goodies.

While professional managers treat the public company as their personal inheritance, shareholders can suffer breathtaking losses. It is quite worrisome that despite a decade or more of boardroom reforms, many directors seem to have become either passive or go-players in this morality issue, unwilling to question the governance of the company and senior management's ethics. This indicates that the market is going through a severe crisis of confidence.

Testifying before the US Senate Committee, employees of companies that drove themselves against the wall, painted a picture of betrayal by some company executives, whose actions left their personnel with huge losses in their pension plans. In a way, no matter how serious the management failure, too often those in charge seem to walk away enriched, while stakeholders are left to suffer the consequences of the senior managers' ineptitude or malpractices.

There is a horde of anomalies in corporate governance, and plenty of moral laxity that pervades all sorts of companies, including the blue chip. For instance, in 2001, IBM used $290 million from the sale of a business, three days before the end of its fourth quarter, to beat Wall Street's profit forecast. This creative accounting was not illegal, but it was entirely misleading.

- A one-time undisclosed gain, used to lower operating costs, had nothing to do with the company's underlying operating performance.

- This and similar accounting entries are distortions that have become commonplace, as companies try to hit a target even at the cost of abandoning fair play.

Creative solutions to financial problems that are at the margin of legality and illegality are multiplying. An interesting case developed in January 2000 when AOL bought Time Warner in a deal worth $183 billion, which later resulted in a $54 billion write-off, the largest ever. Another oversized acquisition came a year later as Larry Ellison, the CEO of Oracle, exercised 23 million stock options for a record gain of more than $706 million. This took place a few weeks before the lowering of Oracle's earnings forecasts.

Another interesting case in regard to CEO malpractice, and its fallout, has been that of Sunbeam. On January 11, 2002, Al Dunlap, its former CEO, agreed to pay $15 million to settle a lawsuit from Sunbeam shareholders and bondholders alleging that he cooked the company's books while he was in charge. Arthur Andersen was not alien to this malfeasance. In May 2001 the certified public accountant had already agreed to pay $110 million to settle a shareholders suit alleging fraud in its audit of Sunbeam.[19]

While big investors try to cope with the aftereffect of CEO malfeasance, small savers face a different type of hurdle. In March 2002 Japan's largest banks decided to lower interest rates on ordinary savings accounts to 0.001 percent—just one-twentieth of the 0.02 percent they paid prior to this decision. *The New York Times* noted that at that rate of interest, it would take 69,315 years to double one's money without accounting for inflation.

As these references dramatize, the cases of malpractices are polyvalent, most often ending in a pattern of self-satisfying executives working under conflict of interest and showering themselves with stock options. At the same time, some certified public accountants are covering financial improprieties by looking the other way. Time and again investors are upset by the fact that boards fail to appreciate the significance of financial information that comes before them, with board members lulled into complacency by the CEO's gifts, a host of benefits, and climbing stock prices that help to increase their wealth.

Right in the middle of that comes the case of institutions accused of manipulating the stock exchange through the gold market. The Gold Anti-Trust Action Committee (GATA) said that the Fed, the Treasury Department, JPMorgan Chase, Goldman Sachs, and others were using the proceeds of gold leases to fund market interventions, and affect the price of gold through derivatives to keep it from rising. According to GATA the result has been a gold carry trade in which the big banks borrow gold cheaply and then sell it; they use the proceeds to invest in securities and other high-yield paper.[20]

6. Spoilage: False Efforts in Cost Control and in Productivity

As far as the survival of an enterprise is concerned, efficiency demands that costs are watched the way an eagle looks for its prey in its territory. A basic principle is attention to detail. Cost control is very important to any business. There exist, however, cases of cost control being carried to extremes till the effort of swamping costs becomes counterproductive.

As industrial history teaches, in the majority of cases businesses have been swinging between too little and too much cost control but typically the latter does not benefit from well-documented studies. Both extremes end up in spoilage. British history books say that Henry VIII was importing bronze cannons from the continent, at great cost. Though harder to cast, the cost of homemade cannons was only 20 percent the price of the imported cannons. Eventually, iron cannons gave Britain an advantage that endured for centuries, combining cost savings with military supremacy.

This lesson has been forgotten and companies paid dearly for their failure to apply the lessons of the past. When in 1998 BP bought Amoco, the British CEO of the combined firm ordered a 25 percent cut in fixed costs across all refineries. Every part of the BP empire had to implement that directive, including the Texas City refinery that had created plenty of sorrows for senior management.

Under the previous ownership, the Texas City plant had been run down and there were repeated warnings about the site's safety. Under both the previous and the BP ownership, the overriding need was for a major overhaul rather than blind cost cutting. Between 1994 and 2004, the Texas City refinery had experienced *eight* blowdown drum incidents causing fatalities. Only three of these incidents were investigated. That was the era of (Lord) Browne who, allegedly, was personally responsible for the blanket cost control policy.

In 2007, Browne resigned from BP, but the spirit of blind cost cutting lingered on. No change was made ever after the Texas City accident, all the way to the Deepwater Horizon in early 2010 that cost BP an estimated $42.7 billion[21]—clearly wiping out all of the Browne "cost savings." Under Tony Hayward, the new CEO, many observers expressed the opinion that these poor management decisions nearly signaled the end of the BP.

The irony of this false cost control story has been that till Deepwater Horizon the company's leadership was confident that it was on the right track. The Gulf of Mexico accident was the awakening. The spirit of "great" but empty pronouncements had a high price and the stakeholders paid for the mistakes of management. There is a common folly in going for big words and high-ticket items, when what is mostly needed is minute, detailed care.

Neither was BP the lone player in the drama of the major oil spill in the Gulf of Mexico. On June 5, 2014, the Chemical Safety Board published the results of its investigation into the Deepwater Horizon disaster, highlighting the significance of the *blowout preventer* (a stack of valves on the seabed) intended to seal the well in case of a leak. This device did not work as intended.

If the blowout preventer had functioned according to its specs, it might not have stopped the initial gas explosions on the rig (which killed 11 men), but it could have prevented the oil from leaking into the Gulf of Mexico. One accident coming on top of another caused a spill estimated at up to 4.2 million barrels of crude oil.

Sometimes a new development fails to function as projected, but it may also be that the original hypothesis did not make sense. Margaret Heffernan provides an interesting example of an incentive that became a cost-saving disincentive. In the 1920s Frank Gilbreth, the efficiency expert and father of motion study, announced that he could shave faster if he used two razors instead of one, but then he spent all the saved time cleaning the cuts he got and covering them with Band-Aids.[22]

That's part of what Heffernan calls the human desire to prefer ignorance to knowledge, and to deal with conflict images. True enough, there are cases of blatant spoilage of money that need to be flushed out and corrected but not all cases are simple, particularly when politics plays a pivot role. In Paris it is said (but not necessarily proven) that about 30 percent of employment at Electricité de France (EDF, a nationalized power producer) is superfluous and can be eliminated—but this is a political and social issue, since firing the surplus staff will raise an already high French unemployment.

When politics take the backseat, overheads become a popular cost-cutting domain. In 2013 and 2014 European investment banks revealed deep cost cuts amid declining trading revenues. Employees at UBS faced up to 5,000 job cuts across the group when the Swiss bank kicked off the quarterly reporting season. Crédit Suisse, Deutsche Bank, and Barclays also parted with staff as they slashed expenses to meet cost control targets. Fixed-income trading revenues, the profit engine for most investment banks since the financial crisis, also fell sharply at the biggest US banks. There was also some churning where higher-paid bankers were leaving and lower-paid personnel were recruited for practically the same positions.

When sound management has the upper hand one can find a great deal of cost-saving examples to be achieved without sacrificing performance. Light-attack turboprops are cheap both to build and to fly. A fighter jet can cost $80 million. The 208B Caravan, a light-attack turboprop made by Cessna, costs barely $2 million. It also costs as little as $500 an hour to run when it is in the air, compared with $10,000 or more for a fighter jet. And, unlike jets, turboprops can use roads and fields for takeoff and landing.

7. Virtue over Pay

Some company presidents have been personally proactive in cost control. Toward the end of last century the laurels went to Raymond J. Noorda who built one of technology's giants: Novell. While his Novell stock alone made him nearly a billionaire, Noorda insisted on flying standby to get a senior citizen discount. Dining out, he liked to eat at Sizzler for the same reason.

As for his salary, Noorda started at Novell in 1983 making $90,000, but when three years later two of his sons began working in the company he decided that for every dollar they were paid he should earn one less. His salary dropped below $40,000, and when his sons left in 1988, he didn't raise his wages. Embarrassed, board members did that for him in 1992, raising his pay to $198,830.

"I just don't like to spend a lot of money for things," Noorda used to say.[23] That was evident at Novell's offices, which defined the word Spartan: Office walls and corridors were so devoid of artwork that Novell employees referred to headquarters as "space station." Even when company revenues were growing 30 percent to 40 percent per year, Noorda instituted spending cuts. "Ray has a maniacal focus on costs. It's a means of setting an attitude at the company," said one of the directors who also acknowledged that Noorda carefully watched the quality of his company's products.

Another great example of a successful CEO who respected shareholders' money is Warren E. Buffett, the chief executive of Berkshire Hathaway. Probably the best investor in life today, Buffett has been known for his position that too many pay plans are "long on carrots and short on sticks."[24] Time and again he has expressed himself against:

- The misuse of stock options by CEOs and their immediate assistants, and

- Their lobbying against an accounting rule that would have made companies charge options to corporate earnings.

Contrary to the majority of CEOs who shower themselves and their inner circle with bonuses and presents, Buffett paid himself a very reasonable annual salary of $100,000 with no bonuses or stock options attached to it. By contrast, shareholders have seen the value of their stake in the company rise almost steadily.

The CEO of Berkshire practiced what he preached also in companies he temporarily took control of. Pay was a vital issue at Salomon Brothers, when Buffett took the helm of the investment bank in the mid-1990s following a disaster. Salomon Brothers' compensation was $1.36 billion in 1994, two- thirds of the total noninterest costs of $2.04 billion.

For Buffett, the pay question was not simply a matter of cost cutting. He felt that high pay levels for certain individuals symbolize much of what is wrong with a firm and an industry. In the individualistic culture of the last two decades of the twentieth century, star performers in the firm received huge salaries that were not necessarily commensurate with their performance (More on the problems that have dogged Salomon Brothers in section 8).

Warren E. Buffett's pay scheme at Salomon Brothers aimed to link pay to profits by setting a threshold return on equity below which managing directors in the client-driven business would receive a relatively miserly 35 percent of their 1994 compensation. If the return exceeded the threshold, the "partners" would take 40 percent of the profits. This was a very reasonable plan, but the investment bank's fat cats revolted because of lust and greed.

What Warren E. Buffett failed to realize in the Salomon Brothers case was that even a powerful manager like he could not stand up to the proprietary traders who gambled with the firm's own money, and who made a dominant share of Salomon Brothers' profits in the late 1980s. John Gutfreund, the former CEO, had contributed to the huge bonuses culture by caving in when asked for outrageous amounts of money. That set the tone for later disruptive battles over pay.

At Salomon Brothers things went awry after the firm was hit by the government bond auction scandal in August 1991. In retrospect, Gutfreund's departure was a crucial turning point. Buffett's attempt to bring back discipline was another milestone. He failed to tie the bonuses to the firm's performance because things had already gone too far and he lacked clout with the traders. His efforts led to a rash of departures by senior staff, which undermined his authority at the brokerage; he was unable to redress a situation that had run out of control.

8. Firing an Inefficient CEO

Underperformance is a characteristic widely shared by poor managers. In the early twentieth century John Patterson, then CEO of National Cash Register (NCR) fired an underperforming executive by moving his desk and chair to the front of the company's factory, having it doused in kerosene, and set alight in front of the incumbent. When he was the boss of Occidental Petroleum, Armand Hammer kept signed in his desk, undated letters of resignation from each of his board directors.[25]

Shareholders and board members have a tough time when they try to kick out poorly performing CEOs. At troubled American Express, James D. Robinson III couldn't escape growing shareholder disgust with how he clung to power. On January 30, 1993, just a week after it had misleadingly seemed that he had secured his position, Robinson declared he would quit as chairman of the financial services company. His decision followed resignations by IBM chief executive John F. Akers, and Paul E. Lego, the CEO of Westinghouse Electric.

This triple fall from the top of the pyramid has been the remit of World War II generation of managers, a group some analysts called "the most powerful ever." Swinging in behind them, and maybe pushing them out, was a new generation of younger managers who tested their wings in taking control.

As problems mounted in American Express's travel-card operation and at its Shearson Lehman Brothers brokerage subsidiary, shareholders and a few dissident directors pressed for change at the top. James Robinson tried to quash the uprising and succeeded in salvaging the chairman's office for himself and the CEO's post for Harvey Golub, his choice as successor. Rather than keep battling, three board dissidents resigned. It was only the news of fresh losses at Shearson, amid record profits elsewhere on Wall Street, that provoked a new fury from investors and finally ousted Robinson.

The sluggish corporate performance by former General Motors chairman Robert C. Stempel and Digital Equipment's Kenneth Smith Jr., opened up a wave of change. But did their successors John F. Smith Jr. and Robert B. Palmer perform any better? Smith may be, but not Palmer, who presided over the final demise of DEC. The law of unintended consequences has been a real tragedy of corporate life:

- Changes occur only after it's too late, and
- Their results can never be projected with precision.

The aftermath of the first bullet is that instead of capitalizing on opportunity, companies tend to respond to crisis. When an entity is down, it is pretty hard to put it together again, restoring its past glory. The most visible result of the second bullet is embarrassment and deception, followed by the very reputation of the directors and of the new CEO being at stake. But staying with business leaders who are not in command is no solution either.

BankAmerica's David Coulter had been chief executive of the newly formed BankAmerica-NationsBank merger only a few months when the enterprise announced a $1.4 billion loss (big money at that time). Coulter fell on his sword right after the losses became public.

Wall Street is always ripe with speculation that "this" or "that" CEO may be the next to go, because he is accountable for something going wrong. Kenneth Burenga, Dow Jones' president and chief operating officer, resigned at 54 in the aftermath of Dow Jones' failed attempt at the financial services business.

A similar story played out at Salomon Brothers as chief executive John H. Gutfreund (1983–1991) made some major mistakes. Perhaps the worst was failing to inform the New York Federal Reserve Bank in 1991 when the firm found it had submitted a false bid in a Treasury note auction.

While he was never charged with wrongdoing, Gutfreund resigned from Salomon and agreed to pay a $100,000 civil penalty. Another major error was cutting a special pay deal with supertrader John W. Meriwether, which badly undermined the firm's compensation system.

Yet nearly after four decades at Salomon, Gutfreund had left a legacy. He had built up the firm from a small, parochial bond house into one of the preeminent capital-raising firms in the world. He had vision and was passionate about the securities business. He told new recruits to come in every morning ready to bite the ass off a bear. Gutfreund had also made a name for himself because of:

- Being able to manage big egos, and
- Gauging losses by the expression on a trader's face.

Under his leadership was created much of the value of Salomon, and then destroyed through a short list of flawed decisions. *Deeper personal accountability* is the answer to these executive failures that can break and sink an enterprise. This deeper accountability existed in America, though it took a leave. Some say that personal accountability has never really characterized the more secretive environments of European firms.

According to knowledgeable observers this is a basic reason why European corporate leaders winced when a few heads among them rolled in the late 1990s. The most prominent were Mattthis Cabiallavetta, chairman of UBS; Hans Wilhelm Gaeb, Adam Opel's supervisory board chief; and Gian Mario Rossignolo, Italia Telecom's chief executive.

In terms of CEO accountability, one of the major and persisting problems in Europe, is that the mantle of chief executive officer comes almost with a sense of entitlement. This is a job to last for years. Somehow investors and the company must learn to live through it. The permanence of the CEO's job is now changing, as the travails of several European companies now hit their CEOs on the head.

One of the basic reasons is globalization: Every public company is bound more or less by the same rules. Investors don't tolerate losses or poor performance for long, and chief executives need to be more in the marketplace than in the boardroom, talking to customers, seeing people who are business partners, and trying to sense what's going on. The ivory tower complex is more or less past, but the challenge of unloading a poor CEO without any collateral damage remains.

It is always tough to get a bad CEO out of the company's system. He will resist, and this inevitably leads to a dog fight. When talking about how to get rid of an inefficient senior executive, Dr. Neil Jacoby, my professor of business strategy at UCLA in the early 1950s, advised that he should be given enough cord so he could hang himself. The whole trick is that he hangs himself before he destroys the company.

Edward I. Koch, the former mayor of New York, describes the exchange of tough words with city executives he wanted to fire thus: "We just walked in and said: 'You have to go', and they said 'We are not going', and I said 'Yes you are, it's just a question of how you're going.'"[26] That's another advice on cleaning up the house of which the reader should take note.

Strong-arm tactics can be effectively supplemented by legal procedures. Donn Vickrey, executive vice president of Camelback Research Alliance, thinks auditors should not just sign off on clients' financial statements. They should also grade the quality of their earnings.[27] For instance, a company that was truly conservative in its accounting would get an "A," while one that used aggressive accounting tricks would receive a "D."

The proper grading of accounting practices is important, even if on the surface they are compliant with GAAP. This can ensure that companies are under pressure to not just make their numbers but also aim for high-quality ratings. It also provides a quantitative basis for judging the quality of management by eliminating the transitory effect of creative accounting practices.

3

Social Ethics and Rising Corruption

1. Social Ethics

Nearly all governments are involved in providing health services, pensions, disability compensation, and unemployment insurance to the citizens of their country. Western nations are heavily committed along these lines, characterizing a social net that is generally considered as live evidence of social ethics. They explicitly define minimum coverage and finance the associated programs with both revenue streams from taxation and by increasing the public debt.[1]

Over the years this has led to a large amount of unfunded liabilities accumulated by programs designed to provide some type of social subsidy to nearly everybody, and most particularly to the low-income segments of the population which has come to believe that they are entitled to it. The easier way out for second-rate politicians and weak governments has been to make these programs mandatory with little or no consideration for the risk they represent to the economy in terms of at least two important factors:

- The weight of the public debt they have created and continue to create, which is crashing the national economy, and
- The distortion of the citizens' personal responsibility as they no more need to care about their health and their pensions, having learned to depend on state support for both.

Rising social costs associated with the State Supermarket and its entitlements have led to unprecedented levels of peacetime debt in America, Europe, and Japan while developing nations are not too far behind. To be reduced, this massive public debt necessitates fiscal austerity. The downside is that together with rising unemployment, reduced economic growth, income inequality, and poor governance, restructuring the sovereign's budget leads to:

- Social unrest in the form of protests, and
- A more radical political response in the form of repressive taxation.

In all Western countries major policy decisions regarding the restructuring of the unsustainable social net have been repeatedly postponed because of internal wrangling, while the debt-ridden economy sinks deeper into recession. This creates threats to both financial stability and government stability. It also keeps the social and political restructuring in suspense through events that happen by default rather than through an exercise of leadership.

Over the past decade, in the absence of a significant economic revival in Western countries, the real income of middle and lower income groups has been decreasing. As a result, the disparity between the rich and the poor has widened while different government agencies take it upon themselves to right the balances. To address just one issue, high unemployment, the Federal Reserve has acted as a not-so-successful fire brigade, finding out the hard way that:

- Unemployment is more complex to manage than inflation, and
- Monetary instruments are blunt tools to manage unemployment, even if central banks keep on using them.[2]

It is far from evident how to get out of the rising public debt trap while preserving social ethics. This situation is so complex that there exists no universally valid solution. The policy of kicking the can down the street is typical of politicians who have no experience of how to gain credibility by solving problems involving social, political, and economic factors all at the same time. If they had, they would have appreciated that in complex cases like this nobody, even the ablest, can get the approach right the first time around because:

- Each case is different from the one that preceded it, and
- Each has too many variables considered to be essential.

Success is based not only on unbending determination and analytical thinking, but also on explaining to the common citizens that, after all, it is their money that is on the line—and it is urgent to preserve the coming generations' income from crushing taxation, which is a crucial part of social ethics.

To ensure that sovereign expenditure does not exceed sovereign income, and, therefore, does not create a new debt, is a matter of sound governance, not of austerity or of philanthropy. Besides, philanthropy, too, has its limits. In Warren E. Buffett's opinion the main reason why a philanthropic act is harder than making money is that in business one goes after the lower-hanging fruit while in philanthropy one is trying to tackle problems that are inherently difficult. For instance, how to end urban poverty.

In addition, the ineffectiveness of philanthropic endeavors is the fault of both those who receive the grants and of those who provide them. Deciding what one will do to make a change happen is a choice that requires not only solid objectives but also careful planning on behalf of donors. At the receiving end, those getting the money should ask themselves: What am I accountable for? What do I offer in exchange?

In many cases philanthropy has lost its focus as a basic social ethic because people look at it under the prism of a one-way process of wealth transfer, which is untrue. During his early years Andrew Carnegie, a Scottish immigrant to America who eventually became the king of steel and a great philanthropist, spent Saturdays and Sundays studying books in public libraries. In remembrance, when he became a multimillionaire he built libraries all over the United States but *if* people do not visit these libraries to learn from the books (which is a give and take principle), *then* social ethics are poorly served.

This is true of all domains of human activity. Richard W. Fisher, president of the Federal Reserve of Dallas, said that the biggest US banks stand to lose their risk management focus.[3] That is absolutely true. Not only the US banks but all big and complex banking groups around the globe have lost or stand to lose their risk control focus (again a give and take principle). They are more interested in all sorts of dealings and less interested in controlling the exposure that they assume.

The sense of balance, which is so critical to social ethics, is simply missing. In its annual reports just prior to a 2011 scandal UBS stated that disciplined risk management and control are essential to its success. That assertion has proved right in the most curious way, after allegedly unauthorized bets cost the bank a whopping $2.3 billion. In the aftermath, Kweku Adoboli, a 31-year-old trader, was arrested and charged with fraud. His case bears striking similarities to that of Jérome Kerviel (section 6), the man who gambled with money belonging to France's Société Générale in 2008. Both Kerviel and Adoboli had:

- Started their banking careers in the back-office, and
- Moved on to trading desks designed to provide clients with derivatives and other exposures,

Adoboli took advantage of a loophole in the securities law by using exchanged traded funds (ETFs, chapter 7) to book fake transactions (ETF rules do not force brokers to immediately produce confirmations of trades). Because by overplaying their hand in trading credit institutions have lost their risk management focus, they are vulnerable to this sort of manipulation.

The blowing of a $2.3 billion is an abdication of *areté* the way the ancients have defined it, which blends ethics and efficiency (chapter 1). Fraud is an antisocial activity that flourishes in an environment of poor management planning and control, where it provides evidence that those in charge are not able to perform their functions. *If* the corporate CEO, or sovereign, makes a detailed study of assets and liabilities under his watch *then* he would know exactly what he needs to do to reach his goal and what he will find when he gets there. But in real life this sort of meticulous study of one's duties and responsibilities has indeed become a rarity.

2. *La Forza del Destino*

To avoid being tempted into a self-deluded belief in their own success, social and political reformers should create social solutions with a feedback. This will force them to hear what may at times be unpleasant truths about the lack of effectiveness in their work, and may be about an absence of ethics. The right feedback is what Socrates called his inner *demon* (section 5) that constantly challenged its master to improve his performance. Any system that does not improve over time, drifts.

Aloofness and the absence of feedback have led the American and European politicians, and their governments, to believe that they can have their cake and eat it too. If one listens to political pronouncements from politicians ranging from Barack Obama to François Hollande he is entitled to doubt that those in charge will ever be able to simultaneously:

- Reduce the public deficit, and
- Create new employment opportunities.

Even a baby nowadays knows that these two goals are mutually exclusive if one wants to pursue them in parallel, but politicians find it hard to make tough choices. If they were not lying to the public politicians would have admitted that even with stringent measures it will take the better part of ten years to clean the public deficit mess, and over this time employment will be lagging as fewer jobs are created to accommodate the young entering the labor force.

A couple of centuries ago, Adam Smith identified the proportion of the population employed and the skills of the workforce as the primary determinants of the wealth of nations: Economic growth and the increase in employment opportunities are correlated. But the present-day overleveraged and dysfunctional economy, instead of producing wealth, tries to find ways to redistribute existing income, privileges, benefits, and "security":

- Without a plan, and
- Without success.

This resembles a communist regime like a twin, even if it is done in the name of democracy (a false assertion) by supposedly center-right politicians. The looting of existing wealth continues, engineered by governments increasingly unable to finance welfare systems. In reality what has become *la forza del destino* is the politicians' inability to get out of the vicious cycle of making "social" promises they know they cannot finance, which creates a bleak destiny.

In an article in the *Financial Times*, Johannes Leithäuser, political correspondent of *Frankfurter Allgemeine Zeitung*, had this to say about two whole months of negotiations between the two major parties that define, between themselves, his country's destiny: "Coalition governments are routine in Germany. Yet the road to the latest alliance of Christian Democrats and Social Democrats has been paved with superlatives: the longest negotiations, the highest number of participants, the thickest contract—and the poorest outcome."[4]

Leithäuser then correlates Germany's destiny to that of the two parties leading to the inefficient outcome of their negotiation, which is bound to deceive the voters of the Christian Democratic party: The negotiations led to an agreement turned to "yesterday" rather than to "tomorrow." He points out that the real winners to emerge out of a 185-page long document are the old:

- Older mothers will gain higher pension for every child,
- Older workers will be able to retire early at 63 instead of 67, and
- People who made only small contributions to the social security system will see their pensions increased.[5]

Despite having taken two months in the making the fiscal policy of this two-party accord is not equilibrated and most evidently it does not favor the future. Its new programs and initiatives will amount to at least €25 billion ($33.8 billion) but no taxes will be raised to finance the extra spending. The politicians hope is that somewhere else, totally undefined, there will be surpluses and they will use that money. More spending, no new taxes, and, at the same time, reducing the deficit is the usual political mythology.

As for the young, who will eventually be asked to pay for the unavoidable new deficits, they better wait so that they, too, when they become old, can get some money or at least goodies from the State Supermarket. Their fate does not interest the leftists running the big mainstream parties, who find most of their voters among the old: old parties, old voters, old garbage. That's *la forza del destino* by choice and not because the gods commanded that the German or any other economy be destroyed.

There is little doubt, therefore, that even if they find a job, the young will be the losers —which speaks volumes of political ethics and inefficiency. The situation of the young will worsen because fewer and fewer employed workers are contributing tax revenues to support the growing numbers of the working-age unemployed and expanding population of the elderly. The impasse was seen nearly three decades ago, signaling:

- The approaching limits to prosperity, and
- The end to the better future that successive generations have aspired since the end of World War II.

The downturn of Western economies partly due to the stated reasons and partly due to a growing body of excesses, alerted to their limits current concepts, priorities, and policies. The potential of outdated values, socialist theories, and associated social strategies has been exhausted, and along with it the ability to look at economic growth as the remedy for social ills.

This is not surprising because economic and financial crises affect everyone. The generation of people born in the 1980s and 1990s believe their aspirations have been deceived. Since the 2007 crisis, earnings have fallen in real terms while student debt has boomed, and it is an increasing struggle to find a job.

According to politicians in power in many material respects, the lives of today's 20- to 30-year-olds are better than the lives of those who came before them. Even if the slowdown upset the destiny of the young generation, there is a safety net still in place to rescue those who fall behind.

Yes, but how solid is this highly expensive safety net? And how long can it last?

Belief in tomorrow being better than today has ebbed as betting progressively shifted from the performance of the economy to the performance of financial markets. According to some economists this is neither natural nor a process of normal evolution. It became inevitable only because of the increasingly fragmented sovereign policies based on:

- Obsolete concepts, and
- The failure to measure correctly the economic repercussions.

With social ethics waning we have lost sight of the basic aim of employment as well as sound debt-free financial policies. Yet these are the fundamental source of economic security for the future. The problem has been aggravated by the growing separation of the banking industry and financial markets from the underlying economies they are intended to serve.

Employment, pensions, health care, and industry at large have depended on the vitality of the underlying economy, which means on the increasing prosperity of the common citizen. This model has been attached by the nineteenth-century socialist doctrine, which, as Lenin said, aimed to take from everyone according to their abilities and give to everyone according to their needs.

This social-communist doctrine is a pure and simple negation of social ethics. According to that force of destiny nobody will anymore have abilities, but everybody will have growing needs. Still the creation of new wealth is not merely a necessary condition for economic growth. It is an essential condition—the economic equivalent of the right to vote in a democracy.

In a market economy, wealth creation is the essential means for providing each individual and household with the purchasing power required for their livelihood while generating the demand needed to support rising production and income levels. This cannot be achieved by increasing the public debt—which has been tried but failed miserably.

Tiny Slovenia, with just 2 million citizens, provides an example. From 2007 to 2013, in merely half a dozen years, its public debt went from under 30 percent to 75 percent—an increase of over 250 percent or 41.7 percent per year. Over the same timeframe, overdue loans of the larger state-controlled Slovenian banks went from about 3 percent to 30 percent, while for small domestic banks it went from 3 percent to 24 percent,[6] still way too high and unsupportable in the medium term.

Since the 2007 economic and financial crisis, Slovenia's defining characteristic has been short-termism, a concept massively applied throughout Europe and the US. With short-termism, the Slovenian economy changed in form while the old socialist *nomenclature* of finance and industry carried on and credit flowed from banks largely owned by the government.

Like other southern European countries Slovenia became the victim of its shortsighted politicians, remnant of a defunct communist regime. Its economic downfall matched that of Greece triggered by a bloated public sector. Worse yet, Slovenia's destiny has been crony capitalism, mismanagement, and a web of politically connected groups linked by opaque cross-guarantees and overly generous loans.

If one needs an example of the absence of social ethics matched by galloping government irresponsibility, it is Slovenia. Slovenia would have been an EU experiment in debt restructuring if it were not for its reluctance to recognize the facts and Germany's political resistance to underwrite another rescue of a self-wounded sovereign. The question is: For how long can a country afford to remain as a zombie economy?

3. Rising Corruption

Corruption is more than a poison afflicting business life. It is part of daily life in business and in government. Every society has a level of corruption. The questions are: How much and by whom? The usual excuse of corrupt individuals is: I did what was best for my company (or for my country). This is of course untrue. Corrupt individuals will steamroll everything, but whether in government or in business the day of reckoning will eventually come.

Corruption is a pervasive issue and therefore not one that can be easily ended, even if the sovereign really wants to do so. Part of the problem lies in the fact that somewhere in the process the proper way of doing business, procurement, ending, running operations, is somehow distorted by politics. Money does not need to be abundant for corruption to flourish. In fact the scarcity of money feeds corruption pushing it to different quarters that, till then, might have been honest.

An integral part of the corruption process is the disregard for ethics, a wrong-way spirit that has even penetrated the larger population of taxpayers. Who cares for state-owned money? There is a joke with a grain of truth in it. It starts with the query: Whose car can you drive at 150 kilometers per hour on a gravel road? Answer: A government car because it isn't yours and you don't pay for repairs.

This is the spirit Confucius, the ancient Chinese philosopher (circa 500 BC), criticized when he condemned "men of false virtue." Corruption is what happens when the appetites of business, government, and the underworld converge. In Denmark, Finland, and Switzerland (which OECD defines as the least-corrupted countries on the globe) such a convergence is far from being a dominant concept. In other countries, however, it is a matter of the daily course of events, as:

- Corruption of the client's executives is instrumental in selling products and services, and
- Political patronage is bought to bypass laws and overcome regulations; corruption opens doors.

One of the key reasons behind corruption is that quite often trickery goes unpunished. This leads to the creation of a torrent of fake products. According to *Le Parisien* of July 18, 2013, 10 percent of the honey sold in France at high prices is fake. The ongoing extermination of bees by pesticides has caused demand to exceed supply creating new "business opportunities," Allegedly produced in China, this honey whose origin is (at best) unclear has already found a good market: 300,000 tons of fake honey have been sold to France.

There is also fake beef made of recycled horse meat. The fraud with horse meat sold as prime beef has reached gigantic proportions. In France alone 50,000 tons have been channeled to the market, making small game of the 750 tons stocked in the commercial circuit of Spanghero,[7] the company originally involved in this scam.

Corruption has many forms and shadows. In the US, the Justice Department announced details of a $3 billion fine on GlaxoSmithKline for over-aggressive marketing and selective use of clinical trials data. The British drug maker has been accused of making cash payments to doctors disguised as consulting fees, as well as providing them with lavish entertainment to encourage them to prescribe its products.[8] The deal that followed resolving a pile of criminal and civil charges has been the largest health-fraud settlement in American history.

GSK is not alone. US prosecutors have accused nearly every big drug firm of unethical sales statistics. Several have settled, including Pfizer, in 2009, for $2.3 billion, and Abbott Laboratories, in May 2012, for $1.5 billion. The Department of Justice has used an old statute: the False Claims Act passed during the Civil War to stop contractors from swindling the Union army. In 1986 Congress gave it new life, promising big payouts for citizens who blew the whistle on firms that defrauded the government.

Legal prodding has been considered important because, all counted, few whistleblowers' stories end "happily." Many people ruin their careers because of it, and there is also the society's aversion to men and women who blow the whistle. Often, they are seen more as snitches than as people trying to clean up the system.

Politicians try, if they can, to steer clear of evidence. In Quebec, despite mounting evidence of links between the mafia, construction companies, and politicians, for more than two years, Jean Charest, the Liberal premier of the province, resisted calls for a judicial inquiry. Instead, he ordered a police probe and created a permanent anticorruption unit. Eventually came the day of truth, in September 2011, in the form of an explosive report from this unit detailing cost overruns totaling hundreds of millions of dollars, kickbacks, and illegal donations to political parties.[9]

One of the made-in-Italy scandals centered on Saipem, the oil services company, for alleged bribes paid to win contracts in Algeria. The majority shareholder in Saipem is Eni, the energy group, in which the state has a controlling stake. The Italian government also owns 32 percent of Finmeccanica, which got involved in a bribe scandal, in 2013.

The political dimension of the Finmeccanica affair centered on alleged bribes paid to sugarcoat the €560 million ($756 million) sale of 12 helicopters to India by Augusta, the Italian defense and aerospace company. One of the twists of this scandal was that Italian prosecutors suspected a slice of the slush fund may have found its way to the Northern League.

India itself is not alien to corruption. In 2012 its toxic telecom scandal rumbled on as the Indian Supreme Court annulled 122 mobile licenses issued in 2008 under a former telecom minister. The minister was tried for corruption and then sent to prison.[10] This was by no means an isolated case. A year earlier (in 2011), the auditor general, a panoply of civil activists, and an assertive press helped to hold other corrupt persons to account. Several powerful figures were tried and jailed, but corruption has still not been stamped out.

Several European governments have major holdings in their country's aerospace and defense industry, but fail to watch that ethical business practices are the order of the day. Both EADS and BAE have had to face investigation for corruption. BAE, which at the time was a British subsidiary of EADS, negotiated a settlement with the US Department of Justice in 2010 for three cases of potential corruption. In this settlement, BAE had to commit engaging a monitor who would report regularly until 2013 on the effectiveness of its internal anticorruption policies and procedures.

Back in 2011 a report by the World Bank *The Puppet Masters* investigated some 150 cases of what it called "grand corruption," involving a total of $50 billion in illicit assets. The US was the worst performer among the countries reviewed.[11] The World Bank recommended that banks and other entities providing registration services should widen their due diligence, and that complex structures with more than three layers of ownership should especially be scrutinized as well as be asked to explain themselves.

4. Scams in the Boardroom

In my book, quite aside from other things, the most persistent scam to come out of boardrooms, particularly in America but also in Europe, finds its roots in the extensive use of lobbyists. Lobbyists working for big companies and pressure groups have taken the legislative process as hostage, while politicians increasingly depend for campaign finance on major business firms: banks, pharmaceuticals, defense contractors, you name it.

Prior to and right after World War II, the US was the land of opportunity. Nowadays the land of opportunity has turned into a land of rent seekers in which business has acquired excessive power and regulators have been captured by those they regulate. Another major problem is that boardroom pay has escalated while average earnings have stagnated (chapter 1). In the background of this development lies the fact that many modern industries work on a "winner takes all" principle, which leads to the rotten perception that the rules no longer apply equally to everyone.

Among an array of scandals whose origin has been in the boardroom is that of "third class shares." With its initial public offering Google pioneered the technology industry's dismal practice of stripping shareholders of voting rights. Then, in mid-April 2012, Google added a twist to it with its plan to add a class of nonvoting shares to prevent its founders from being held accountable.

Suddenly this unethical practice in a free economy is becoming a trend. A batch of Internet IPOs—LinkedIn, Groupon, Zynga, and Facebook—has dual-class share structures. Silicon Valley companies like to boast how they change the world for the better by challenging incumbents. But when it comes to being challenged themselves on how they run their business, they choose to be entrenched.

According to several investment experts, Google's C shares are a new low in corporate governance and wealth management. The wider opinion is that it is time for both the New York Stock Exchange and Nasdaq to review rules permitting dual-class share listings and to protect investors from boardroom manipulations—a protection fundamental for safeguarding American capitalism.

Another scam to emerge from boardrooms is defrauding investors who are treated as second class while professional managers and traders are treated as first class. This also works on the "winner takes all" principle. Particularly with hedge funds single-digit returns for investors often translate into double-digit returns for hedge fund managers. The predominant model is a fee structure with an investment strategy attached to it.

- Institutional investors and high net worth individuals assume all the risk.
- In return they collect less than half the profits.

In essence, investors are subsidizing the lifestyles of hedge fund managers. Pension funds and others complain that this is not the responsible way to manage assets belonging to millions of ordinary savers, and that it surely breaches the hedge funds fiduciary responsibilities. In spite of it, however, investors still patronize hedge funds.

Another critique of hedge fund managers is that they use investors' money *as if* it were their own. An example is Philip Falcone, a billionaire hedge fund manager who runs Harbinger Capital Partners. He borrowed $113 million from his hedge fund to pay his 2008 taxes. The money was repaid in 2010. That caught the attention of the Securities and Exchange Commission (SEC) and the Department of Justice, which investigated the "loan," Investors did not see this as a harbinger of good things to come and withdrew some $900 million from Falcone's $6 billion hedge fund.[12]

A different example is that of John Paulson of Paulson & Co, a bigger, $37 billion hedge fund. He was the largest shareholder in Sino-Forest, a Chinese forest plantation operator accused of fraud by short sellers in early June 2011. Its share price plummeted and Paulson sold his stake, dealing its fund a reputational blow and confronting around $500 million in losses.

Other scam cases are more classic. For instance, SAC Capital. US prosecutors called SAC a "magnet for market cheaters" and filed criminal charges against the $14 billion hedge fund. The criminal indictment detailed an expansive scheme alleging Stephen Cohen, SAC's CEO, was at the eye of the storm. The case involved rampant insider trading, said the US attorney in the Southern District of New York, adding that the fraud was "substantial, pervasive and on a scale without known precedent in the history of hedge funds,"[13]

Using the government's forfeiture powers prosecutors sought as much as $10 billion from SAC. FBI assistant director George Venizelos said: "SAC—through the actions and inactions of its management—not only tolerated cheating it encouraged it. The SAC compliance department was like the embodiment of the phrase, 'See no evil. Hear no evil. Speak no evil.'"[14]

Hedge funds are by no means the only parties in boardroom scandals. On June 5, 2008, Federal officials unsealed indictments charging Henry Nicholas III, Broadcom's cofounder and CEO, with drug distribution and stock options backdating. Returned by a Federal Grant Jury, the indictments charged Nicholas on 25 counts including:

- Securities fraud
- False certification of financial reports
- Filing false statements with the Securities & Exchange Commission, and
- Conspiracy to acquire and distribute controlled substances.[15]

A month earlier, in May 2008, regulators had charged Nicholas and Henry Samueli, Broadcom's other cofounder, in a civil suit for falsifying the company's reported income leading to what was considered to be the largest US accounting restatement yet. The basic charge was that of backdating stock options.

A boardroom scams that made big news was that of Bernie Madoff, a wealth manager and former chairman of Nasdaq. He had invested his clients' money in risky stocks that went belly up. Instead of coming clean and admitting his mistake, he borrowed plenty of money to buy back their shares, easing the losses and keeping up the impression that he was a brilliant money manager. Madoff's Ponzi scheme, valued at $65 billion, allegedly began after the 1987 stock market crash, prompting investors to withdraw billions from his fund.

The irony is that the investors' trust was restored because many people looked at Madoff as a consummate Wall Street insider, though his illegal activities were nearly uncovered several times. After a windfall of tips the SEC investigated Madoff's outfit, but in spite of spending hours going through his double trading records they found nothing irregular (or at least that's what was officially reported).

The end came in the wake of the crash of 2008 when Madoff was unable to find enough cash to meet all the redemptions. He finally confessed, and his sons turned him in. Madoff claimed he pulled off this massive fraud alone, but according to prosecutors several of his employees falsified records of nonexistent trading activities even if they declared that they knew nothing about the Ponzi game.

A different but also colorful scam uncovered the same year was that of Milberg Weiss. In the go-go years of mergers and acquisitions that preceded the deep economic and banking crisis, Melvyn Weiss was one of the most feared and hated men in America's corporate boardrooms. Along with his partner Bill Lerach, Weiss had invented a new sort of litigation—the shareholder class action.

Over the years companies had paid out more than $45 billion as a result of the Weiss and Lerach lawsuits. In 2007 Milberg Weiss was legal counsel in 17 suits that settled for a combined $3.8 billion—but the tort innovation itself was illegal. The secret behind the shareholder class action was waiting for a firm's share price to fall, searching for some way to blame this on management (like an evident blunder or an inappropriate public comment), and suing for compensation on behalf of shareholders.

- Several courts awarded huge sums to shareholders, prompting companies to settle out of court.
- Ironically, however, the bill of any settlement was ultimately paid by the firm's shareholders, since in practice they were suing themselves.

Weiss and Lerach have not been jailed for their tort innovation but for the payments they made to people bringing cases, after it became harder to start shareholder lawsuits following a change in American law in 1995. They allegedly had on call clients, even though the practice was illegal. Why is it illegal for a lead plaintiff to take money from his lawyer in a class action suit? Because in doing so he suddenly has a conflict with the rest of the class for whom he is supposed to be fighting. In February 2008, Lerach received a two-year sentence. On June 2, 2008, Weiss got a 30-month sentence and a fine of $10 million—peanuts compared to the profits they had made.

The lesson to be learned from these cases is that crooks are inventive; they find ways not only to bypass laws, rules, and regulations but also to capitalize on them. A principle in financial services is that the attempt to design a system for zero fraud, or zero failure, is mission impossible. Given sufficient time all complex financial systems, and several simpler ones, are open to exploitation. The greater the belief in their ability to withstand stress and avoid scams, the higher the probability of the abuse to which they will be subjected.

5. A Stew of Sorrows and Deceits

Aside from scams in the boardroom, a worse problem a company can face is to have a rubber-stamp board of directors. Such a board can manage neither *feedback* control, a tool for ascertaining if a firm's operations are moving in the desired direction and if the behavior of its senior management has been observed, nor *feedforward*, a tool that defines a range of activities along which things should be moving.

The activitiesinclude human resources, R&D, innovation, prices, markets, costs and other critical issues that can make or break a company. It also embraces and implicates personal responsibilities and ethical issues, which should always be at the top of the list for the board's attention and carefully monitoring.

Stockholder activists claim that corporations have captured the Western economies and some of the developing countries' economies as well. They have capitalized on a political system, and taken freedoms with the national wealth, without assuming any of the responsibilities of dominion. Therefore stakeholders, especially institutional shareholders, must assert their duty to oversee the companies in which they invest.

Another issue motivating shareholder reaction is the so-called proxy access. In some Western countries, new rules allow shareholders to press for the right to nominate candidates for board membership on the proxy voting materials distributed ahead of the annual meetings.[16] Still another is personal responsibility. When they fail to meet stockholders expectations and/or the company's own projections board members start being held accountable.

Personal responsibility and the issue of excessive executive pay (chapter 1) are correlated. Another smoking gun is the growing lobbying power of corporate interests and the removal of property to offshore holdings where it is neither taxed nor regulated. While pay and bonuses are excessive activist shareholders also claim that most boards are not adding value to the corporation because they are not being properly educated to further the competitive advantage for the company they lead.

Lackluster performance is one of the top reasons why banks are in for a rough time. Extravagant bonuses don't make the board and senior management more efficient. Paying for results must be a steady challenge confronting professional managers, traders, and other highly paid personnel.

Not only should overall pay, which includes fixed salaries and other benefits, come down if the deliverables do not meet established objectives, but the decisions and actions of senior managers, particularly bank executives, should also be monitored by stockholder activists. According to some opinions, this is the prelude to a new era to be characterized by greater discipline.

Critics say that some of the reasons for underperformance can be laid at the door of business schools and the inadequacy of the education that they provide, particularly on issues relating to strategic decisions, analysis of feedback, and the ability to make forward plans. While one of the board's duties is to exercise some control on chief executives, decisions on the competitive strategy of the firm are just as vital. Indeed, the board's strategic role is very different from that of line executives as it ranges:

- From supervision to ensure that the company's strategy is right and well implemented,
- To cooperation in overcoming blind spots by either supporting or correcting the course chosen by line executives.

The board's contribution is particularly vital as chief executives are overwhelmed, overstretched, and confronted with rapid rise in the complexity of operations. They are under pressure from the market, governments, global changes, new risks and developing opportunities as well as shifts in economic conditions. In contrast to the daily pressure on CEOs and their immediate assistants, the board's actions are not driven by pressure, and this helps in a more objective response to these challenges.

To put it differently, in a highly competitive and fast-moving industrial environment boards should not only monitor the company's performance, but also actively contribute to it. Board diversity is important in foreseeing sudden industry shifts and disruptive moves. Ideas and personal contributions, albeit more tactical than strategic, can also come from employee representatives.

Still another contribution expected from a modern board of directors is that of flashing out, controlling, and swamping nascent scandals. One way of achieving this is by rethinking and cleaning up the communications system. In the case of the Libor scandal (chapter 7), for example, after probes into benchmark manipulations proved that chatting can drive trading floors, some major banks banned the use of most group chat rooms.

The manipulation of the Libor lending rate prompted the Royal Bank of Scotland to ban unmonitored chat rooms where traders discussed market topics with rivals. Citigroup, too, banned chat rooms with multiple banks, restricting instant messages to conversations with traders from one institution at a time.

The board has a role to play by promoting the control of messaging systems as well as in initiating global probes of other weaknesses. If the board does not take that initiative, regulators will fill in the vacuum. Indeed, regulators in the US, Britain, Switzerland, and Hong Kong are busy investigating more than 15 big banks at date of writing. Traders have been suspended amid suspicions that chat rooms were used to share sensitive client information and other data that led to manipulations.

Still another board responsibility is that of ordering special audits to ascertain whether or not senior management is in charge of costs and risks. This is far from being a widespread culture. According to an article in the *Financial Times*, in November 2013, after the Japanese government recapitalized the ailing Japan Airlines (JAL) and changed its CEO, the new chief executive discovered that it took the country's once-flagship airline a full 50 days to figure out whether it was making money or losing money on any given day.[17]

Like many other companies, JAL was focused on sales while costs escaped the top management's attention. Also, like so many other companies, the airline had never developed an information system that could enable it to be run efficiently. It is no secret that companies that don't control their costs and keep them well below their income are not able to survive, let alone prosper.

Mismanagement is, most likely, the most widespread scandal of them all. The range of scams is expanding. Of late interest rate fixing has been joined by an extensive probe into the alleged manipulation of the $5.3 trillion-a-day global foreign exchange markets This involves not only dealing rooms in London and New York but also the so-called Tokyo fixing, a group of Japanese currency benchmarks considered to be vulnerable to abuse.

Like Libor interbank lending, currency exchange rates are based on submissions by banks instead of real transactions. In Tokyo, at 9:55 a.m., each of the large banks publishes the rates at which it is willing to carry out transactions, which they typically keep fixed for the rest of the day whatever the intraday volatility. This is in contrast to the 4:00 p.m. WM/Reuters currency fix in London.

Global investigations are led by regulators in the US, Britain, and Switzerland with assistance from the Hong Kong Monetary Authority (which has not yet started its own formal investigation). Curiously enough, Japan's main market regulator, the Financial Services Agency, would not say whether it is taking part in the international probe into alleged foreign exchange manipulation.[18]

The resolution of problems relating to operational risk and other similar exposure is a "must" because once lost market confidence is tough to regain. Investors and other clients of the banking industry are no longer as willing to accept deceit, overcharges, and mishandling as they have been in the past. New regulatory changes add to the pressure to revamp policies, systems, and procedures. Evidence is now available that the large and complex banking groups (LCBGs) that run the banking industry are taking notice. This, however, is not yet a universal conscience.

6. The Greatest Scam of Them All: Turning a Blind Eye to Unintended Consequences

In the 1980s in Afghanistan, America supplied Stinger missiles to help Afghan fighters against Soviet helicopter gunships. Not all of them were used in action. In later years the American military spent time and money to comb the bazaars of the Middle East and Southern Asia to buy them back. According to some sources, several of the Stingers bought in arms bazaars were then booby-trapped and sold again, to deter anyone wanting to use them.

The whole Earth is now booby-trapped by the unintended consequences of the population explosion and no government, no political or religious leader is talking about the greater danger this involves. Even the greens, who say that their action is dedicated to the protection of the environment, are turning a blind eye to the time bomb of runaway birth rates, yet they know very well that:

- Pollution increases as people multiply, and
- It accelerates as the standard of living rises.

Pollution and the spoilage of natural resources are correlated to each other as well as to greater population numbers. Homo sapiens are a destructive force on Earth: forests pay a big part of the price; overfishing empties the seas; intensive agriculture poisons rivers, lakes, and underground water sources; COs emissions destroy the air and raise the environmental temperature; chemicals deplete the ozone layer. But all those who should take a keen interest in preserving the Earth's environment, from sovereigns to common citizens, turn a blind eye.

Instead, there is alarm when water resources are poisoned, famines devastate the worst-off communities, tsunamis and typhoons return the earth to nature, liberating it from the destructive effects of the Homo sapiens. How much of a productive area does each person need to maintain his current standards? The answer ranges from 0.4 hectares in India to between 3 and 4 hectares in Europe and 5 hectares on America—an average of 1.5 hectares per person. *If* humanity continues to exploit Earth with the:

- Cruelty, and
- Indifference

It has so far shown, *then* the day of reckoning will not be that far. Not only Homo sapiens but also apes, which reproduce very fast, face extinction. For humans in particular the economic, social, and environmental impact of unsustainable usage of the Earth's resources can hardly be ignored.

Take water as an example, since it is at the heart of food security. Agriculture still accounts for over two-thirds of global water withdrawal. While irrigation systems have made large areas accessible to production the dependency on renewable water resources originating from outside sources:

- Renders water-scarce countries vulnerable, and
- Poses a severe threat to the health of billions, without a sustainable solution in sight.

A worldwide water stress is emerging as an immediate environmental risk. In a late 2011 *Global Risk Report*, the World Economic Forum (WEF) asserts that respondents to its global risk survey consider a water supply crisis to be the most likely and most severe exposure of societies for the next ten years. According to the Food and Agricultural Organization (FAO) 2.8 billion people are currently at risk of water shortage and, with global demand expected to grow further, two-thirds of the world's population is projected to live under water-stressed conditions.[19]

If you think that desalination technology will solve that problem, think again. True enough, over the past three decades, the production of fresh water from the sea has risen ninefold despite concerns about its environmental impact. There are now over 15,000 such plants worldwide and more than 300 million people rely on desalination technology for water—among them the citizens of Saudi Arabia and the United Arab Emirates.

Success with desalination is far from being the general case. The award-winning €300 million ($405 million) desalination plant at Torrevieja on Spain's arid southeast coast is now laying idle. It is also Europe's largest facility for converting seawater into fresh water, and the second biggest in the world. While the central structure has been built at great cost, neither the pipes to the sea nor the power transmission lines have been approved or constructed. Even if one day this plant does begin to process seawater, cost projections suggest that the fresh water will be so expensive that nobody would want to buy it.

Financed by taxpayers' money and €55 million ($74.3 million) of European Union regional development funds, the Torrevieja plant has been repeatedly challenged on both environmental and financial grounds. Madrid's own estimates suggest the desalinated water would cost between two and four times as much as the project's agreed selling price of 30 cents per cubic meter, and it is far from clear who would pay the difference. In the meantime this idle desalination plant has joined the other Spanish white elephant, the €1 billion ($1.35 billion) empty airport at Ciudad Real in central Spain as showcase of the folly of big and poorly studied projects.

Neither is clean water scarcity the only challenge with unaffordable birth rates. Another test is migration to cities and massive urbanization, which presents its own challenges. Large sprawling cities are more vulnerable to health hazards and prone to large losses should they be hit by natural disasters. Healthcare cover becomes more critical, particularly for an aging population less and less able to rely on the younger generation for post-retirement support.

Cities have expanded into megacities of 10 million or more inhabitants. It is projected, that by 2025 that there will be 37 megacities around the world, up from 23 in 2011. This is sure to bring fundamental socioeconomic change, and a new risk landscape emanating from higher population density. Megacities will try to cope, with questionable success rates, by providing migrants with access to basic needs but the threat of social unrest will hang over them like the sword of Damocles.

Accommodating an ever-growing urban population entails huge infrastructural investments. It is estimated that between 2014 and 2030 $43 trillion will be required to serve the needs of urbanization alone. More will be needed to guarantee the constant functioning of roads, highways, and bridges whose quality has been dropping worldwide due to substandard maintenance.

In addition, electricity production and distribution, sanitation, and waste management are critical for sustainable urbanization. Other big-ticket infrastructural facilities are airports, high-speed rail links, mass transit systems, hospitals, and health services in general. City dwellers tend to eat convenient and processed foods linked to obesity, diabetes, heart disease, stroke, and some cancers.

Continuous exposure to high levels of noise leads to hearing impairment, high blood pressure, and heart disease. City dwellers are also highly exposed to air pollution. The World Health Organization (WHO) estimates that 1.5 billion people in towns and cities face dangerous levels of outdoor pollution. Indoor air pollution is also severe, especially in emerging markets, causing chronic disease and cancer.

According to environmental specialists heat from cities is causing a new type of pollution: a phenomenon in which temperatures in urban areas are higher than the surrounding countryside. Radiation from traffic, air conditioners, and industrial facilities is still another problem.

Construction materials used in cities such as concrete and asphalt that absorb heat are adding to the causes of heat pollution, which causes discomfort and sleepless nights leading to excessive use of electricity.

Waste disposal is still another major issue. The waste from homes and offices in an industrial city totals millions of tons. The number of discarded cans rises rapidly as the demand for a variety of canned drinks grows and vending machines continue to increase. Hence the need for public awareness of the problem and for necessary steps to prevent the living environment and scenic places from deteriorating under mountains of trash and garbage.

Urbanization and industrialization are correlated. Turning a blind eye to safety associated with projects and constructions leads to loss of life. An example of this was the blaze killing 117 people at the Tazreen factory on the outskirts of Dhaka, Bangladesh, that made clothes for Western supermarkets. Averting such disasters requires substantive safety investments from an industry under pressure to supply cheap clothes to the West.

Rising labor costs in China, the world's biggest clothes maker, have promoted Bangladesh as the world's second biggest garment producer. Bangladesh's 3.6 million garment workers are also among the lowest paid in the world. Its clothing exports surged but many of its 5,400 garment factories still lack basic safety measures, with highly flammable fabric carelessly kept in corridors.

All sorts of companies, even those with reputations as quality producers, have become careless. In January 2013 Toyota settled a class-action lawsuit in America over instances of sticking accelerator pedals that led to a big safety recall of its vehicles in 2009 and 2010. The Japanese carmaker compensated drivers under the terms of a settlement that lawyers for the plaintiffs valued at around $1.4 billion.[20]

A case of a blind eye in finance has been the IPO of Facebook. The information made available was criticized as having been inexact and incomplete, violating established rules. Institutional investors kept out; they allegedly had better information than common investors. Mark Zuckerberg, the firm's boss, and the underwriters who supported its IPO have all been sued by disgruntled shareholders who claimed that less wildly optimistic growth forecasts for the company were given to favored investors just ahead of the floatation, but withheld from the market as a whole.[21]

There is also the case of financial and trading excesses to which bosses turn a blind eye in the hope of greater profits and unprecedented bonuses. Jérôme Kerviel, of the French Société Générale, is an example of a scapegoat for such practices, blamed by his former employer for €4.9 billion

($6.6 billion) of trading losses incurred in January 2008. His lawyer cast the 33-year-old trader as a country boy from Brittany who entered a virtual world in the soaring glass towers of SocGen where "numbers had no meaning."

The trader's lawyer focused on the deficiencies in SocGen's controls and its €11 billion ($14.8 billion) write-downs relating to the US subprime mortgage crisis. This paints a picture of a risk-taking bank operating in a chaotic financial world with little, if any, in terms of management control. "This is the story of a liar, it is the story of a faker," answered a lawyer for SocGen in the court in his summing up but without explaining how the big bank had turned a blind eye to the trader's losses that were reaching for the stars.

4

Ethics and Efficiency in Public Administration

1. Lack of Ethics and Inefficiency in *Absurdistan*

Cicero (106–43 BC), the Roman senator and orator, had said that society is made by eleven professions: The poor who works, the rich who exploits him, the soldier who defends both of them, the taxpayer who finances the previous three, the tramp who rests for the four, the drunkard who drinks for the five, the banker who swindles for the six, the lawyer who deceives the seven, the medical doctor who kills the eight, the undertaker who buries the nine, and the politician who rides on the back of all ten professions.

A different way of dividing society is into two large groups: those who work and those who don't, the specialty of the latter being that of putting batons between the wheels of the working people. If you think that the latter are the government's bureaucrats, then you are right. As an old joke has it, the difference between a bureaucrat and a piece of wood is that wood works.

From the moment of joining the administration, and becomes a card-carrying member of *absurdistan*, the young employee readily learns the meaningless office language of bureaucracy and his career flourishes. His friends who are in private business can no longer understand him, but this is irrelevant because bureaucracy lives in a closed world by itself and for itself.

Theoretically, but only theoretically, this bureaucratic language is designed to eliminate ambiguity and promote efficiency, even if it pays little regard to practicality. Its deliverables can be summed up in huge volumes of paper tied with sinister red tape and deadlocks—which are the power of the powerless, an exclusive domain of *absurdistan*.

The world of bureaucrats is enriched by politicians who share common interests such as preserving the status quo, opposing structural reform, and finding a myriad of excuses—but no effective solutions—when economic progress stalls. The most common of these excuses is that a major recession or depression is somebody else's fault, as José Luis Rodriguez Zapatero, the former Spanish socialist prime minister, put it so nicely (more on this later).

Absurdistan's greatest enemy is the working man, but this danger remains elusive because politicians and bureaucrats populate the left, the right, and the center controlling all high positions. This build-up is particularly impressive under socialist regimes (as well as different forms of dictatorship), because its inertia serves well those in power—though it keeps in servitude the majority of the common citizens who vote them in and out of power.

The Social Democratswere once the parochial party of government in Sweden, having been in office for 66 of the past 82 years. Among other accomplishments it introduced the country's famous cradle-to-grave welfare system, funded by high taxes. But the public had enough of it. A recent Swedish opinion poll found just 28 percent support for the Social Democrats, a record low for the party of the Left and a far cry from the 40 percent or more that it once took for granted.

One reason for socialism's fading appeal has been its failure to provide an answer to Sweden's aspiring middle class. As in practically every other country, in Sweden socialism was a nineteenth-century regime stuck on help to illegal immigrants, galloping welfare, and sick pay. That's the regime that might work when life is hard, but it is not the solution for people who have jobs and believe in the future.

Neither is it true that when they come to power politicians who would like to be remembered as being Left party innovators bring along some bright ideas. Evidence of this can be seen in Barack Obama's first budget in 2009 that called for repealing his predecessor, George W. Bush Jr.'stax cuts on the rich, eliminating tax breaks for multinationals, and boosting the tax rate on capital gains. That was the intention but it did not turn out that way.

The next couple of years Obama repeated Bush Jr.'s tax policies. Even in 2012, AU: the Obama administration's fourth budget recycled Bush Jr.'s old stuff. The budget deficit boomed. In the first year of Obama's administration it stood at 10 percent of GDP; the democratic president projected that it would fall to 3.5 percent in 2012. Instead, it stayed stuck at 8.5 percent—way too high and adding a great deal to the US public debt. (Obama's contribution to *absurdistan* is examined in section 2, particularly in connection with Obamacare.)

Using public money, the Left-leaning fat cats had a ball. There is a saying in Britain that, when they come to power, the goal of the Labor party's fat cats is to make money through different deals that feeds corruption. By contrast the Conservative party's wheelers and dealers are more interested in sex. *Absurdistan*'s corruption is typically served through a mix of populism and leftism.

Brazil is a case in point. Since the beginning of Dilma Rousseff's career as the country's president, the Workers Party and its allies took many freedoms with the republic's wealth. When *Veja*, a Brazilian weekly magazine, published evidence of systematic overbilling on contracts at the transport ministry, Rousseff fired dozens of officials, including the minister—but the layers of corruption run much deeper than that.

When *Veja* reported on similar overpayments and kickbacks in the agricultural ministry, the number two at the ministry was sacked while the minister resigned. A short time thereafter police arrested more than 30 officials in the tourism ministry, including the deputy minister, on suspicion of using public money intended for training hotel staff ahead of the 2014 football World Cup for personal reasons. Scandals have been shaking Rousseff's administration, a shaky coalition that consists of over a dozen parties ranging from communist to right-wing populist.

According to a widely held opinion, the main interest of some of the coalition's minor members is the extraction from government of jobs and money for personal gain and party financing.[1] Were these the usual teething troubles of a new regime? It does not seem so. Two and a half years down the line *absurdistan*'s high stakes with public money continued as strong as ever.

José Dirceu was believed to be the second most powerful man in Brazil. Then claims came to the public eye that he and other WorkersParty leaders were orchestrating a scheme to bribe allies in return for congressional support. Dirceu resigned and some days later, on November 15, 2013, Joaquim Barbosa, the supreme court president, issued warrants for his arrest along with11 others found guilty of bribery, money laundering, misuse of public funds, and conspiracy.[2]

According to news from the South American *absurdistan* Dirceu is not alone in Brasilia's prison cell. Sharing the facility are José Genoino, a former Workers Party president, and Deubio Soares, a former party treasurer. Henrique Pizzolato, a former director of the state-owned Banco do Brasil, who was found guilty of money laundering, fled to Italy.

The socialist culture of *absurdistan* has deep roots in Spain. The case of Zapatero—the former prime minister—is one of gross inefficiency. He was the country's chief of state for seven years (2004–2011), and left behind a country teetering on the edge of the precipice. In November

2013 Zapatero told CNBC, the financial network, that the loose monetary policy pursued by the European Central Bank (ECB) overheated Spain's housing market. It was the ECB's and not his personal mistake that the Spanish real estate boom was followed by a dramatic bust.

The crash of the overleveraged real estate market hit Spain's banking sector like a hammer. This happened under Zapatero's watch but according to the former prime minister, in *absurdistan*, the man in charge is not responsible. When things go wrong the scapegoat has to be found elsewhere.

"The monetary policy of low interest rates—followed since the birth of the euro right up till the crisis—was designed for the German reconstruction. But what effects did it have for countries like Spain? It created a huge expansion of credit . . . which created bubbles," said Zapatero.[3] He and his Spanish Socialist Workers' Party were in no way accountable, even if they were in power:

- As the housing bubble grew, and
- When the bubble blew devastating the Spanish economy.

Zapatero also provided evidence of being illiterate in terms of chronology. World War II ended in 1945. A mere 15 years later not only did Germany rise from the ashes but also in 1961 the deutsche mark was revalued by 5 percent against the dollar, which speaks volumes about the strength of the economy. Germany did not need the euro to reconstruct itself; instead its joining Euroland was the price it paid for its reunification.

As for Zapatero's claim that loose ECB interest rates helped boost demand for German products and allowed the country to build a large trade surplus, it is untrue. Low interest rates have been maintained by the ECB to help the southern Euroland countries, particularly Greece, Italy, and France, to pay the interest of their huge public debt. If interest rates were high France, Italy (and the US) would have followed Greece into the abyss.

2. From *Absurdistan* with Love: The Unaffordable Care Act

It would be a mistake to believe that *absurdistan*'s ineffectiveness is limited to socialist regimes. Early on, the Bush Jr. administration introduced a system for sizing up passengers for signs of suspicious behavior, like excess anxiety. Known as the Screening Passengers by Observation Technique (SPOT), it was put in place to identify terrorists at busy US airports. According to the US Government Accountability Office (GAO) there is no evidence that SPOT has caught a single terrorist—though it singled out people with immigration offenses, drug charges, and outstanding criminal warrants.[4]

Technology let George W. Bush down, as years later it would Barack Obama who bet on mismanaged technology connected to the so-called Affordable Care Act (ACA), which is really *unaffordable* for a weakened US economy. Bush Jr. and Obama share another saga: the questions raised about their efficiency, their lack of credibility, and their effectiveness in providing solutions to tough problems—fiscal problems in particular.

Effective solutions require increases in taxes or cuts to entitlements that go well beyond the nation's means to support them. As President Eisenhower pointed out in the 1960s, minor concessions are no way to balance sovereign budgets. They simply fail to solve the debt problem.

Unable to implement an overarching vision and a revision of all expenditures, politicians consider fiscal policy as a short-term proposition through bargaining sessions against looming deadlines. Delaying tough decisions, however, diminishes the likelihood of politicians being able to guide the nation's economy and makes the problem of mounting public debt even more difficult to solve.

Though few regimes really master economic planning, under socialism and populism planning is largely a matter of wishful thinking, if not of outright fantasy. No serious attempt is made to understand the developing economic weaknesses as well as the strength and nature of global competition—including the practical educational support required to keep ahead of the race.

Owing to political interference, lethally combined with the bullish optimism of socialist politicians who see only "opportunities," the results being obtained are substandard and, as such, they guarantee failure. By being mismanaged, even well-intended projects become merely futile and costly sideshows exacerbated by irrational persistence to see them through, no matter how high the costs might be.

There is no better example than the (Un)Affordable Care Act, the ill-studied and poorly implemented Obamacare along with the complex law supporting it. It was projected to achieve many things all at once:

- Offer a new health scheme to uninsured Americans,
- Preserve the private insurance system in the US,
- Expand accessible and affordable insurance plans,
- Eliminate discriminatory policies against high-risk patients, and
- Be so ingenious that it would not cost the federal government a dime.

Obamacare was overambitious, costly and made on the run; it was no surprise, therefore, that it failed in all its five objectives. Judging from the results, Obama's optimism was grounded more in *absurdistan*'s hopes than on thorough planning. Just six months prior to its official launch, McKinsey, a consultancy, privately warned the White House that its wonder was at risk of failing, two of the reasons being that:

- The government had relied too heavily on outside contractors, and
- The system would not be sufficiently tested before the planned October 1, 2013, launch date.[5]

According to well-informed sources congressional investigations and interviews with healthcare industry experts pointed out a list of poor hypotheses regarding this project. The Obama administration, however, disregarded that advice and missed red flags that date back to 2010, the year the act was passed. One of the major weaknesses was IT procurement. A host of individual contractors signed off on portions of the project and they were subjected to scanty supervision.

Washington should have tested Obamacare well before its launch. Instead, it was tested for only about two weeks and crashed days before going live. As a result of mismanagement Obamacare's rollout failed so badly that only 106,000 people were able to sign up for insurance on the exchanges in the first month when 500,000 were expected to do so. Several other problems also emerged, severely damaging Obama's credibility, including his now-discredited promise that every American who liked his or her existing health insurance would be able to keep it.

There was a mare's nest of background reasons to this fiasco. Not only was preparedness wanting and the law too complex, but the ACA objectives were also badly chosen and poorly integrated among themselves. For instance, it would have been logical to expect that first medical and pharmaceutical costs would be carefully trimmed before even the implementation plans reached the drafting board. Instead, nothing was done to curb medical inflation prior to extending health insurance to the millions of Americans who lack it.

The financing, too, was lopsided. The cash-strapped were to receive big subsidies, while insurers were barred from charging more from those who were already sick. In essence, the healthy citizens were obliged to buy health insurance in order to subsidize the sick and their abuses. The ludicrous failure identified a president with little interest in details and a disdain for study and analysis, who tried to impose a gigantic change on the whole country:

- All at one go,
- Far too casually, and
- Based on weak or outright wrong assumptions.

In mid-November 2013 a CBS News poll showed that Obama's approval rating had dropped to 37 percent, the lowest he ever recorded, while 61 percent disapproved of the health reforms. Quite evidently, this gave the Tea Party movement ammunition in its crusade to prove that, a priori, big government condemns itself to a hard time.

Many American voters came to doubt Obama's honesty. When selling his reform, he repeatedly told the American public things about his healthcare initiative that were simply untrue. Bill Clinton is reported to have commented that Obama got all the hard stuff right, "but didn't do the easy stuff at all."[6]

One of the more bitter criticisms was expressed by American citizens who interpreted Obamacare's travails as a manifestation of the administration's insular culture, in which those who disagree with the president's wishes are seen as naysayers and few outside his inner circle are trusted. Indeed back in 2009, in internal White House debates, Rahm Emanuel, then Obama's chief of staff, was reportedly urging the president to scale back his ambitions on healthcare reform and pursue a more modest policy—but Obama refused to accept a downsized plan and pushed ahead.

Flying on the wings of hope and luck, he saw his luck run out. According to available evidence he did not ask the all-important queries: What is the reality? What are the real dangers? Not only has this failure raised many questions but it also confirmed that it is not possible to undertake major projects without commensurate preparedness. The "hope" that things will fall in the right place through their own will—and big government does not have to bother about disorder—can only bring fruits in *absurdistan*.

3. NATO's *Absurdistan*: A Fake Mullah Omar Feasted in Kabul

Another *absurdistan* is the absence of a common defense policy and of homogeneous interchangeable weapons by the European Union member states. Critics say that this is symptomatic, a debilitating fear of EU members in making military commitments. But the absence of a common defense policy sees to it that, on military issues, different EU countries have different positions on NATO and its future, particularly on how to handle:

- Regional European conflicts (like Bosnia),
- The rationale of foreign expeditions (like Iraq and Afghanistan), and
- The EU's, and individual countries', relation with the United States.

All three bullets lead to foreign and military policy tensions that make decisions on other pressing issues more difficult, while political courage remains a scarce resource. NATO has by now become an alliance split down the middle, starting with the fact that the EU's foreign policy arrangements, themselves, are in a shambles.

The opposition by France and Germany to intervention in Iraq and subsequent pro-intervention stand in Libya (and Syria) by France and Britain are not the only discords; they are illustrations of initiative driven by domestic political considerations and by global commercial plans to sell weapon systems. They are, as well, examples of ineptness in managing military projects fed by the fact that those undertaking them don't really believe that they worth their salt.

It's a situation full of folklore as a couple of examples help in documenting. The first dates back to the year 2000.The way it has been reported by the press, on March 29, 2000, a fake senior US Air Force officer supposedly attached to the North Atlantic Treaty Organization headquarters was about to grant billions of dollars in contracts for a top-secret NATO project that called for cutting-edge computers, communications, and software and services.

- Companies that wanted to participate could not speak a word about this "top-secret" project to anyone, and
- The gear that companies submitted would be, in the officer's words, "tested to destruction," Prototypes would not be returned.

Claiming to head procurement for a project that would contract equipment for up to €120 billion ($162 billion) over five years, the imposter persuaded many companies—who failed to test his credentials—to send in for testing tons of their most advanced hand-held transmitters, digital disk makers, video cameras, and flat panel displays. (Some of these flat panel displays were later found full of pigeon droppings in a

Belgian loft.) Nobody seems to have bothered to know more about that "high-ranking" officer.

An estimated 90 different companies sent tens of millions of dollars worth of equipment to a fake NATO Materials Test Unit labs in Belgium designated by the officer in question. Among them were some of the most venerable names: Sony, Pioneer Electronic Data Systems, 3Com, Adobe, and others. Based on bankruptcy-court filings in Belgium and on estimates by law enforcement officials, their losses totaled more than €50 million ($67.5 million).

That was the high-tech gear whose whereabouts were either not found, when an effort was made to recover it in conjunction with court proceedings, or was unusable. The fake NATO officer had in the meantime dropped out of sight, while his true identity and even his nationality remained unclear.

Con games like that do happen in *absurdistan*. The puzzle is that the next one took a whole decade to show up. The place was not Belgium but Afghanistan. On November 23, 2010, an imposter duped NATO officials into thinking that he was a senior Taliban commander, ready to talk on peace terms in exchange for appropriate compensation.

Apart the money thrown to the four winds, this incident dealt an embarrassing blow to attempts to open talks to end the war in Afghanistan. The alliance helped fly the imposter to meetings with the government in Kabul under the assumption that he was Mullah Akhtar Mohammad Mansour, one of the highest-ranking members of the insurgency, and right hand of Mullah Mohammed Omar, boss and spiritual leader of the Taliban.

After repeatedly fooling Afghan and Western officials and being paid large sums, it was discovered that the man parading as Mullah Akhtar Mohammad Mansour was a fake. According to one account, in real life he was a shopkeeper from the Pakistani city of Quetta. Playing down the controversy, Hamid Karzai, Afghanistan's president, denied reports in US media that he had met the fake mullah but the media insisted that the Karzai meeting had indeed taken place.

The *absurdistan* part of the incident is that senior Western officials had endorsed the Afghan government's attempts to try and open talks with various strands of the insurgency, and therefore they were trapped in their own game, by acknowledging some form of political process needed to end a war grinding (in 2010) into its tenth year.

The pseudo-Mullah incident also brought to the public eye the diverging positions among NATO members, with Sky News having reported a month earlier the words of a key Taliban leader who said to the TV station's correspondent that Britain was the Taliban's No. 1 financier—not the government, mind you, but British moslems who provided a great deal of funds and arms.[7]

On November 26, 2010, the *Washington Post* quoted Karzai's chief of staff as saying that the British had introduced the imposter, and unidentified British officials had brought him to meet Karzai in July or August 2010. Moreover, this *absurdistan* incident underscored the uncertain and even bizarre nature of the atmosphere in which Afghan and Western leaders are searching for ways to bring the American-led war to an end.

According to some accounts different indices pointed to the fact that Afghan officials realized the man was a fake when people who knew Mullah Mansour said they did not recognize his photograph. But no matter the fake, Pakistani officials seized on the incident to renew their call for a role in any discussions on the future of its neighbor.

The public airing of the scam and of hefty payments to the imposter also made uncomfortable reading for General David Petraeus, the then NATO commander in Afghanistan, fuelling speculation over the scope of Taliban contacts. The fake mullah episode also seemed to contribute to a growing hostility among Afghan officials toward Western diplomatic interference in Afghan policy matters, despite the billions of dollars spent by the international coalition to support the corrupt Karzai government. Bravo to everybody. Next time make it a musical comedy.

4. The North-South Divide Has Become a Global Hallmark

In an article published in the *Financial Times*, Hans-Werner Sinn, president of the German IFO Institute for Economic Research, said: "Greece, Spain and Portugal need to devalue in real terms by about 30 percent relative to the eurozone average in order to correct the distortions... (created) by the inflationary credit bubble... and to restore their competitiveness."[8]

A 30 percent devaluation is not feasible while the three countries stay on the euro, neither are Euroland's member states that need a major devaluation limited to the trio. Italy is surely a fourth candidate for a 30 percent devaluation of its currency, which would roughly represent 2 percent per year since Italy entered Euroland. This will be in line with the steady, annual devaluation of the lira adopted by Italian governments since the end of World War II. Add to this lot tiny Slovenia and the result is five European Union countries in economic turbulence, all in southern Europe.[9]

- Italy was downgraded to BBB+ by Fitch in March 2013 and to BBB by S&P in July 2013, but may be cut to Baa3 by Moody's.

- Slovenia's credit rating was downgraded by all three major agencies between February and May 2013, and is now junk-rated at Moody's.

As far as the economy and the country's creditworthiness are concerned, there also exists a border case between Euroland's north and south.

- France, whose rating was cut to AA+ by Fitch in July 2013 and downgraded to AA by S&P in November 2013. Its healing will take a long time.

With the exception of the de Gaulle years with the *franc lourd*, after World War II, like Italy, France has followed a steady currency devaluation policy albeit in big jumps rather than on a smooth annual basis. During the seven years of the first presidency of François Mitterrand (in the 1980s), the French franc was devalued three times by a total of 8.5 percent.

It is precisely for these countries and their high public debt, particularly France with a public debt of €2 trillion and Italy with a public debt of nearly €2.5 trillion, that in mid-November 2013, Mario Draghi, of the European Central Bank, brought Euroland's interest rate down to 0.25 percent. This was an unwelcome move that amounted to further expropriation of savers.

The southern EU debacle in economic, financial, and banking terms is something new in the global landscape. For over three decades after the end of World War II all European countries belonged to the so-called First World[10]—the rich countries. By contrast, members of the Third World were all of Latin America, all of Africa, all of Asia (except Japan, but including China).

That model does not hold water anymore. China is the second economic power in the world. Like Japan, South Korea, and Taiwan it is also a *north* Asian country. The world has witnessed the outperformance of manufacturing- and export-oriented North Asia and a big wealth gap between the Asian North and South, which continues to widen. As November 2013 came to a close, some investment banks downgraded India to least preferred while Indonesia continued to remain in that least preferred class for investments.[11]

Other excellent examples are provided by North Asia and there are also exceptions in the Asian South like Singapore, which performed an industrial miracle. Countries that shed their misery and moved ahead of their lot transformed themselves into economies with strong manufacturing and export activity. No wonder therefore that their sovereign credit metrics continued to improve.

By contrast, in recent years in Indonesia and India the amount of easy money, and therefore credit growth, has been excessive. Hence, they are now more vulnerable to higher global interest rates, particularly in an extended credit cycle. The same is true of France, Italy, Spain, Portugal, and Greece—the European Union's south that lived too long on credit in a hopeless policy of improving its standard of living without putting up the effort to reach that goal.[12]

The opposite policy has been followed by Germany, which has been working hard to improve its standard of living, and so also Switzerland, Norway, Sweden, and Finland. Britain, too, may be on its way to getting out of the deep recession tunnel. Notice that this did not happen while the Labor government was in power and socialist policies of spend-and-spend dominated the British sovereign's policy and the economy. The resurgence began under the conservative-liberal coalition.

As far as creditworthiness is concerned, Germany, Switzerland, Norway, Sweden, Finland, and Denmark have AAA credit rating with a stable outlook. Compare this to Spain's BBB-, Portugal's BB, and Greece's B-, and you have a qualification of the divide separating the European Union's North and South—not unlike the north-south dividing line in Asia. It's a different world than the one we knew in the post–World War II years and by all evidence, whether in Europe or in Asia, this divide will increase.

Absurdistan's big joke is the so-called United Debts of Europe, an euphemism for the *mutualization* of public debt pushed by François Hollande, the French president, with Enrico Letta, the Italian prime minister seconding. The two (and sometimes others) hope to unload their sea of red ink onto the other EU members—who see the plot and reject it.

Hollande even had the guts to say that the Eurobonds would not be used "for growth" (read: throwing money at the unemployment problem). This was precisely the opposite of what he had stated when he was elected president, which is another example of the inconsistency of politicians.

It is totally silly to continue with handouts. The north-south divide we are talking about makes the often-mentioned *Eurobonds*, jointly guaranteed by contradictory economic realities between savers and profligates, a tool of the *absurdistan*. Though southern political leaders may desire a common funding with Eurobonds, the necessary concessions are highly unlikely to be supported by people in a democratic decision process. It follows that:

- Euroland's crisis will continue to impact financial markets, and
- It is better to avoid peripheral government bonds as well as investments in banks located in or strongly exposed to these countries.

Another brilliant "spending and spending" idea that was grounded was to get money from the European Investment Bank (EIB) for "projects." EIB said: Yes, provided the projects are well studied and justify the loans. But to come forward with funds for projects by the profligates, EIB has to increase its capital, which means that the profligates have to put money in before taking money out.

Rather than going hat in hand for money of the mind, southern European political leaders should ensure that their social net is redimensioned in a way that receipts match expenses. As for the European Central Bank, it should carefully restudy its policies before it obliterates the savings habits of Europeans. Germans have been saving, on average, a little over 10 percent of their net income. With interest rates practically zero, savers have been taken to the cleaners—and not only savers.

To escape from the deadly embrace of negative real interest rates that the ECB *and* the Fed have made intoa sort of permanent reality, pension funds, too, have been obliged to take risks not commensurate with their status. Neither is this very low interest-rate environment without other risks over the long term. Apart from fears of inflation, a puzzle confronted by the Federal Reserve in tampering with quantitative easing is how to get out of it without turning the economy on its head.

As Hans-Werner Sinn stated, the flood of money from countries with high budget deficits and skyrocketing public debts along with negative real interest rates has calmed the capital markets, but the price has been abandonment or slowing of the realignment of the prices of goods needed for improving competitiveness in Southern Europe. Sinn referred to an International Monetary Fund statement that:

- Industrial production in Italy, Spain, and Greece has fallen dramatically, and
- Hardly any of the recent trade improvements in Euroland's south have come from increased competitiveness.

As if this mismanagement was not enough, on November 13, 2013, the EU executive in Brussels launched an inquiry into whether Germany's current account surplus was harming the European economy. At best, the logic of such an argument is coming straight out of *absurdistan*, and at worst it is plain communism. The profligate EU members want Germany to pay for their extravaganzas in mismanaging their economy. But, according to José Manuel Barroso's twisted logic, Germany should not be allowed to export.

Instead of improving their competitiveness the profligates want to destroy what works: German exports. Barroso, who started that funny investigation, should be ashamed of himself. He and the other EU commissioners (read: bureaucrats parachuted in Brussels) should understand the risk that penny-a-dozen populist measures, which are discrediting the EU Commission, will have knock-out effects on the so far very limited and ineffectual *reformettes* by France, Spain, Italy, Portugal, and Greece.

Socialist and populist politicians in these countries interpret Barroso's critiques as an opportunity to relax their own reforms, irrespective of the fact that growth in German demand would not help them until their exports become more attractive featuring, at the same time, higher quality and lower cost. Becoming competitive requires major reforms in Southern Euroland rather than continuing the status quo in *absurdistan*.

5. Bubbles Are the Ticket to Economic Disaster

In his CIO Monthly Letter Alexander S. Friedman, the chief investment officer of UBS Wealth Management, writes: "Kids love blowing bubbles…a shiny sphere floats off, defying gravity. And when the bubble bursts, laughter usually follows. Investors tend to like bubbles too—until they pop. Tears, not laughter, are the likely reaction."[13]

Economic history is littered with bubbles. The more famous among the early ones have been the tulip bubble out of Holland; the Mississippi bubble out of France, under the reign of the Duke d'Orléans, viceroy during the infancy of Louis XV; and the South Sea bubble out of England when Isaac Newton was master of the mint, a job equivalent to the governor of the Bank of England. Newton lost a small fortune with the South Sea bubble and made his famous statement that it was impossible for him to calculate the madness of crowds.

Rumors, greed, and speculation feed that madness, and the bubble, defying economic theory and making small game of the analysis of fundamentals. Financial bubbles are an exercise in *absurdistan*, but they are by no means random events. Big bubbles are carefully developed and managed to attract silly players particularly in their early years, till they gain their own momentum and market follow-up.

Considered to be the Earl of Oxford's masterpiece, the South Sea Company was established in 1711, theoretically with the aim to restore public credit. Its assets were largely based on misinformation and a long list of lies, but this did not deter investors from rushing to join it. As the madness of people for easy profits increased, the company's stock reached for the stars.

One of the rumors, based on no evidence whatsoever, was that Spain was willing to concede to the South Sea Company four ports on the coasts of Chili and Peru. Negotiations to that end did take place but the only result was the *assiento* contract to supply slaves from Africa to the Spanish colonies in the Americas. Philip V of Spain admitted no other British trade to *his* possessions.

In spite of this, the Earl of Oxford declared that in the first year Spain would permit two English ships to carry on merchandise during the first year and after that all ports and harbors of Spanish America would be open to trade with Britain. Other pronouncements, too, were made so that the name of South Sea Company and its lucrative business (a fata morgana) were continually before the public.

- The anticipated eventual failure of the company's plans was a well-kept secret, and
- Nothing deterred investors from throwing their money to the company whose stock continued to rise.

The sovereign, too, helped the bubble grow. At the opening of the 1717 parliamentary session, the king's speech made reference to the state of public credit, recommending that proper measures be taken to reduce the national debt. The South Sea Act passed by Parliament was intended to contribute to that end.

As it happens with most economic and financial bubbles, the imaginary wealth had captivated not only the rich but also the not so rich creating a self-feeding cycle for the stock's price that went from one hundred to three hundred to six hundred, and over one thousand pounds. "The great principle of the project was an evil of first-rate magnitude," says Charles Mackay. "It was to raise artificially the value of the stock by exciting and keeping up a general infatuation and by promising dividends out of funds which could never be adequate to the purpose."[14] The Ponzi game was invented there and then, in early eighteenth-century London, not in early twentieth-century Boston by Carlo Ponzi as different books have it.

After the bubble burst, people wanted justice and Parliament voted for an inquiry. The public asked for punishment, and parliamentarians were happy to oblige. The first to be in the eye of the storm were the South Sea Company's chief executive and its directors. They had profited from insider information unloading their shares near their peak value; but soon it was found out that there were other individuals as well, particularly politicians, who shared inside trading privileges—and the blame.

The concept is that of swindling people who trust you, a feat that can be undertaken by an unscrupulous earl, a wheeler-dealer, priest, or anybody else. In 2012 with a nudge from their pastor, the 25,000 members of the New Birth Missionary Baptist Church (near Atlanta) opened their hearts, and their wallets, to Ephren Taylor and his glittering credentials. Taylor billed himself as the youngest black chief executive of a publicly traded company. He had appeared on networks like NPR and CNN, and given a talk on "socially conscious investing" at the Democratic National Convention. He was also running a charitable endowment.

With this background, when Taylor's "Wealth Tour Live" seminars came to town, faithful ears listened. The church's leader, introduced the "famous" visitor at one event with the words: "[God] wants you to be a mover and shaker…to finance you well to do His will." The investments Taylor offered were reportedly chosen with guidance from God, who wanted them to be:

- Low-risk, and
- Of high performance.

In the background was a swindle, and before too long divine inspiration gave way to legal proceeding. For many investors, the 20 percent guaranteed returns by God's commercial and financial representative had proved to come out of *absurdistan*, and Taylor stood accused of fraud in a number of lawsuits. That bubble was not the first blot on the minister's reputation: In 2011 he settled for roughly $20 million, but not for a financial bubble. The accusation was that he had coerced young men into oral sex.[15]

From earls to preachers another one of the vices swindlers share is bloody vengeance. If anyone dares to talk against their dirty game, he is compared to Cassandra, predicting evils that are only believed when the bubble bursts. Over the years several known people spoke against "this" or "that" fraud scheme—like the half-a-decade long quantitative easing—but their warning fell on dull ears, as greed and speculative frenzy usually carries the day, with visions of riches dancing before the public's eyes,

This belief in absurdities makes it difficult to differentiate between bubbles and outright cheats, with the result that fraudulous outfits proliferate. When doubt and questioning are in short supply, the company or investment plan continues being bubbled up with thousands of simple, hardworking, honest people being taken in by the turbulence till they are penniless. Typically, politicians who don't care about their reputation are found to be no less guilty than the directors in terms of:

- Notorious fraud,
- Breach of trust, and
- Widespread corruption.

In often-encountered pervasive cases shares have been issued well beyond the level authorized by the company's statutes and many were unaccounted for in terms of their whereabouts. The Cosmo scandal in Japan provides an example. A fictitious sort of equity was distributed among several members of government and of parliament by way of bribe, to facilitate the passage of the bill necessary for the company's public perspective.

It is superfluous to add that in such cases a company's books are usually cooked. Names and numbers are altered. "Corrections" are made in several accounts and many pages are missing from the books making it nearly impossible to find out who made how much in illegal profits. The rules to remember are that when, like Icarus, a company soars too fast, too high toward the sun, the wax of its wings melts and it falls into the sea. This might have been learned in 1720 with the bursting of the South Sea Bubble but over the intervening three centuries it has been forgotten. Hence, the same tricks are being repeated and they are followed by the same results.

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Be Ready for the "Unthinkable"

1. Thinking of the Unthinkable and Its Aftereffect

Part of the basic philosophy of sound management is that moment by moment every "good thing," every acquired asset, every business relationship stands on the razor's edge of change. Often, though by no means always, the aftereffects of that change are unpredictable, while their timing and direction are not evident in advance. This is particularly true when one or more political decisions trigger that change. Still prognostication is vital; hence the need for forecasts.

We can learn a great deal by going through past forecasts, comparing them with the facts of business life. In mid-April 2011, a financial analysis by Bank of America Merrill Lynch put in the following terms its expectation of events over the next three to six months:

> Because a credit event on sovereign debt is a political decision and a credit event on high yield is more of an economically-driven outcome, sovereign credit events are hard to predict…The recent market response to news that S&P was placing US government debt on a "negative outlook" reiterates the point that a major credit event in a key bond market participant would have very negative consequences for oil prices and the global economy.…We remain of the view that high prices could help trigger a credit event in the next 3 to 6 months.[1]

At the time this prognostication was made, the credit event in reference could only be imagined by thinking what a short time earlier might have been unthinkable: a downgrade of US creditworthiness. The global economic situation would have worsened by a simultaneous bankruptcy of Greece and Portugal, pulling down with them Italy and Spain but not raising the question: "Who is next?"

The need for thinking the unthinkable is by no means a twentieth- or twenty-first- century phenomenon. Here is an example from 1797, which was one of the most curious times in history. In that one year, the British invented the income tax, which was unthinkable up to that time, and the French implemented military conscription—another first.[2] Then, like now, the world had to face new developments that had come at a fast pace, and the only way to be on top of the situation was (and still is) to:

- Challenge the obvious,
- Pay attention to outliers and rare events, and
- Adjust swiftly to the new situation, rather than falling behind by default.

This is true for everyone, from sovereigns to common citizens, as well as for the economy at large. For instance, in the domain of bank regulation Basel III presented new rules aimed to correct the failures of its predecessor (Basel II), which had relied too much on certain key assumptions.[3] In the aftermath Basel II had paid scant attention to rare events, and the "unthinkable" happened by way of a meltdown of big global banks that thought they were sitting on top of the world.

With Basel III regulators called for the introduction of leverage ratio limits, capping the total amount banks could lend relative to their capital. The free lunch with gearing is not over, but it is constrained. Basel III also mandated that credit institutions should maintain high-quality, liquid assets sufficient to survive 30 days of acute short-term stress—which is still an insufficient provision but is, nevertheless, a "first."

At least theoretically the capital and liquidity proposals should result in more resilient banks and a sounder financial system. Practically, however, nothing can be taken for granted. Again, theoretically, the ethical standards are higher with Basel III than with Basel II; practically, only time will tell if this is indeed so. There are still more significant challenges in terms of the:

- Room left for circumvention,
- Consistency of implementation, and
- Way regulators will apply the new rules or turn a blind eye to their violation, as it has happened so often in the past and in the present.

In thinking the unthinkable there is also the sorry state of sovereigns to account for. Governments and central banks rushed to lift up from under the self-wounded, big global banks and they paid a high price in terms of their own creditworthiness. To paraphrase three of the four themes advanced by Franklin D. Roosevelt in 1932 in his attack on the mismanagement of the American economy by the Hoover administration:

- First, Washington encouraged speculation, through false economic policies (so did other Western capitals).
- Second, it attempted to minimize the crash, misleading the people as to its gravity, and
- Finally, it refused to recognize and correct the evils at home that brought it about.[4]

Roosevelt appreciated the fact that each country faces its own unique set of circumstances, particularly at the time when elections and leadership transitions approach. While the specifics vary from one jurisdiction to the next and there are some broad themes widely shared across countries most likely to leave a heavy footprint on the policy landscape for years to come, the key issues to influence policy outcomes are:

- The domestic economy,
- The evolving role of government in economic matters,
- Proposals for tackling rising levels of public indebtedness,
- The shifting tides of social unrest, and
- A sea change in public perception about market outcomes that increase the significance of special interest groups, and therefore the ambiguity of political programs.

Examined in unison, the themes invite more government involvement in economic matters. At the same time, structural budget deficits and rising public debt burdens impact the government's strategy and tactics. *Strategy* is understood to imply the art of conquest by means of a master plan. Whether at the corporate or at the national level strategy achieves its aims through tactical moves that concern the execution of operations under a master plan. *Tactics* is subordinat to strategy.

At the level of the administration, strategy and tactics are themes that repeat themselves all too often usually, though not always, at a higher level of complexity. This is compound by the high level of government indebtedness throughout the Western countries fed by unstoppable budget deficits and obligations being assumed without studying their consequences.

Government-sponsored enterprises like Fannie Mae and Freddie Mac, the giant mortgage recyclers, were by no means the only major liability for the US government. Other bottomless pits are Medicare, Medicaid, and Obamacare (the government's healthcare programs), student loans (at about $1.3 trillion), and much more. Neither is this just an aftermath of the economic crisis. In July 2008, the Pension Benefit Guaranty Corporation (PBGC), which insures private sector benefits, was $14 billion in deficit.

Mid-2008 was indeed the time of the unthinkable. Lehman thought the rules would not actually be applied to Fannie and Freddie, but that was brushed aside by sellers determined to assume the worst. Contributing to the market's jitters was the rumor that IndyMac Bancorp had been told by regulators that it had insufficient capital (it went bust a short while thereafter). In the aftermath, it was slashing its loan book—while in Britain the share price of Bradford & Bingley, another mortgage bank, sank even further, dropping a long way below the rights-issue price and reopening debate about its future.

For credit markets, these banking problems were doubly ominous. They caused the industry to cast about for more capital, but there was no reliable, let alone forthcoming, source of supply. In California investors were rattled by a run on the bank that began after Senator Chuck Schumer questioned IndyMac's health. The federal agency that insures deposits took over and the bank reopened under the management of the feds. Despite assurances, thinking about the unthinkable, hundreds of angry customers queued up to withdraw their savings.

2. Debt Forgiveness in the Ancient World

One of the misconceptions to be avoided is that ethics and efficiency are wholly concerned with money and other material goods. In fact, the principal inputs to an ethical and efficient business behavior are themselves a product of previous activity that, to a significant extent, involves personal interests, training, beliefs, culture, actions, and reactions not always concerned with money—even if, as an old saying has it, "Money makes the world turn round,"

In social and economic life individuals, companies, and sovereigns deploy their human (nonmaterial) and material resources in an interplay that, on a number of occasions, may fall short of moral rules, efficiency principles, or stated objectives. Or, may end in indebtedness, which impacts the economic view of people, things, and places. Chronic *indebtedness* acts as a poison on the economy as a whole and not only on personal lives.

To better appreciate what stands behind the message conveyed by the preceding paragraph, it is wise to start this section with some basic definitions. *Debt* is a sum of money or other valuable assets owed by one party to another. A party can be a person, a company, an institution, or a sovereign. Debt comes into being through granting a *credit* or raising a *loan*. The debt ratio to one's own capital is known as *leveraging* or *gearing.*

Typically, albeit not always, a *creditworthy party* capitalizes on its status by applying for loans, obtaining the use or possession of goods and services without immediate payment. *Consumer credit* is extended by banks and shopkeepers to individuals; by contrast *trade credit* characterizes transactions connected to manufacturing and merchandizing houses.

- Virtually all exchange in the production and distribution services, hence of commerce, is conducted on credit.
- Loans are characterized by their volume (amount of money involved), interest rate, and maturity (when their repayment is due).

Consumer and trade credit have been to a large part *bank credit*, with the bank acting in its transitional role as an intermediary. Credit may as well be extended by a counterparty to a transaction, for instance, the vendor of goods and equipment; or obtained from the capital market where companies sell their bonds (financial obligations) to willing investors.

Another important category is *sovereign credit*. Governments with budget deficits take loans from banks or issue bonds, thereby increasing the public debt. In a way similar to that prevailing in industry, these loans may be *secured* or *unsecured*; and they may be senior (to other loans) or junior.

In case of *insolvency*, the inability to pay back the loan due to financial constraints, a court of law decides that the borrower (whether individual or company) is bankrupt. A bankruptcy petition may be filed either by the debtor or by his creditors. In regard to trade credit—hence in the case of a company—the debtor's assets are realized (through sale) and distributed among his creditors. Typically, there is not much to recover in consumer credit bankruptcies, unless the debtor has given collateral to the bank as a condition for the loan.

Things are somewhat different if the consumer has used the loan to buy an asset, for instance, an automobile. Banks collect a pool of asset-backed financial papers,[5] securitize them, and sell them to investors. Asset-backed securities (ABSs) can also be based on other financial instruments, like credit card receivables and student loans.

The securitization of debt has significantly expanded the financial market and widely spread its risk. But when consumer indebtedness reaches for the stars not only the debtors but also the whole economy suffers. Under conditions of wider economic stress other solutions have to be found, some of them considered to be "unthinkable" in normal times. For instance, debt forgiveness.

Debt forgiveness has happened twice in the ancient world,[6] and hit hard all creditors. The first time on record was under Pisistratos, the tyrant of ancient Athens. History books say that the debt forgiveness significantly improved the plight of agricultural workers by relieving them of a part of their debts. Apart from debt forgiveness, Pisistratos advanced money to agricultural workers so that they could restructure their finances and earn a living through their work in the fields.

Debt forgiveness was also prevalent in the Roman Republic. An economic crisis had hit Roman agriculture hard while a sudden block in trade following the resurgence of war with Mithridates, king of Frigia, resulted in a severe drop in tax revenues from the eastern provinces. That complex situation created a cash flow crisis for Rome and for many of its citizens, and it was exploited by Catilina's *popularis* movement, which focused its political program on a general cancellation of debts.

Historians (rather than economists, as should have been the case) are still arguing how much popular support that general debt cancellation policy attracted. Precise evidence is missing. What is known is that then, as now, the web of credit had spread through every level of society. If it were adopted by the Roman senate, debt cancellation would have benefited the poor more than the rich. But in many respects it was shifting the problem of financial damage around the system, replacing one set of bankrupts with another.

The Roman debt crisis did not subside after Catilina lost his cause (and his life); in 47 BC it landed squarely in the hands of Julius Caesar. In Rome and its dominions, the civil war had brought financial activity to an almost complete standstill and a renewed debt crisis was creating serious social unrest. No surprise, therefore, that the issue of total cancellation of debts surfaced again.

But Caesar was too intelligent and shrewd a politician not to realize that total debt cancellation was no cure, and its aftermath would be far worse than the disease. To cope with the situation before it got out of hand, he issued what some historians judge as a well-considered decree, which:

- Obliged creditors to accept land at prewar values as repayment, and
- Allowed up to a quarter of the value of a debt to be set off against previous interest payments.[7]

Besides this, Julius Caesar enacted at great speed a number of other important and well-judged reforms. He acted evenhandedly and favored neither conservative nor radical causes, making decisions on the merits of each case. Wars aside, his first priority concerned the social and economic problems of Rome and its people, which, evidently, had financial consequences. A variety of measures should be an integral part of a macroeconomic analysis because they provide evidence. The associated *what ifs*:

- Should be examined in the light of current conditions, and
- Be used as food for thought in terms of extreme but real events.

Nobody able to think the unthinkable can ensure that such a partial payment in specie cannot happen again. Neither is Caesar's example the only one in financial history, where the sovereign turns the tables on his subjects hurting all of them to some extent.

In the second half of the eighteenth century, the French state was in financial trouble. To resolve the problem, in March 1770, Abbé Terray, the new *Controlleur General* (finance minister), suspended payment on a number of government securities, including one class called *rescriptions* in which Voltaire had invested a large amount of money. Not only Voltaire but several other French citizens were also hurt.[8] Abbé Terray was faced with the alternatives of suspending payments or outright confiscating private money; he chose the former approach as the lesser evil.

When the disastrous Asia Minor war ended in 1922 Greece was bankrupt and so was Turkey to the point that Ismet Inonu, the Turkish prime minister, said that there was no point in asking the Greeks for reparations, because "they are as bankrupt as we are." To get relief from its debt the Greek government cut the value of the legal tender to half: A 100 drachma note in your pocket was worth only 50. (Along a similar line of thought, in the 1980s, in Italy, d'Amato, a socialist prime minister, taxed every citizen's bank deposits by 6 percent.)

Bankers and other lenders wise enough to learn from history would never say: "This can never happen again," because it can very well happen. According to Walter Wriston, Citibank's CEO, sovereigns don't go bankrupt. But they do. An example is the bankruptcy of Argentina, which wiped out more than $100 billion, with the Argentinean government taking Catilina's approach for total debt forgiveness, then coming up with a tricky "plan and road show" to wipe out nearly 75 percent of its debt.

In the first week of November 2011 François Fillon, the then French prime minister, left no doubt about the implication of the French Republic's 2012 budget and its fallout on the euro when he said that the word "bankruptcy" is no more an abstraction. France's public debt reached €1.8 trillion, making the republic the fourth most indebted country of Euroland. In 2011 the deficit was €95 billion, or roughly 10 percent of the French government's budget. During that year the gap between receipts and expenditures widened by almost 50 percent because the expected growth in the economy did not materialize.

Unwisely, the government had tuned its fiscal policy and budget with a projection of 1.75 percent growth in the economy. By October 2011, however, economists forecasted no more than an anemic economic growth of 0.5 percent (The government had said 1.0 percent), leaving a gaping hole in the budget. The Ministry of Finance estimated it at €8 to 9 billion, which proved to be an underestimate.

Since 2012 was a presidential election year, Paris was in no mood to take tough budgetary measures. Instead, the government decided to go ahead with a minor increase in the value added tax (VAT) for restaurants and house improvement work, from 5.5 percent to 7 percent, expected to bring about €1 billion; a surtax on big firms, another €1 billion; and cuts on the government's own expenditures of €0.5 billion. That's peanuts. Even so a public poll found that 71 percent of the French public was against such "tough austerity measures."

The public mood was not for saving money. The welfare state, which had transformed itself into a mammoth State Supermarket, was hungry for cash. Beyond its own financing requirements France had to commit €158 billion to Euroland's European Financial Stability Fund. Could it afford it? It could if the government decided on true austerity measures, but there was no austerity program. Instead, what was brought forward was:

- A mixture of measures contradicting each other, and
- Expenses that should have been avoided, like a nuclear submarine and €300 million spend for the intervention in Libya, which ended badly.

As far as the euro and Euroland are concerned, the salient problem was to identify to which group France belonged: to the hard workers and savers like Holland, Germany, Austria, and Finland or to the profligates like Greece, Italy, Spain, and Portugal. To a very large extent this was a matter of French politics, and because politics involves many surprises, people are asking, "What's the next unthinkable?!"

3. The West's Crisis in Finance, Banking, and Business Confidence

According to Herbert Hoover, greed has no part in leadership. It only spreads dissatisfaction, ill feelings, and anger, igniting competition for more lust and greed. Which then are the qualities a chief must possess to bring the economy up from under? The answer given by the former president of the United States can be summed up in three bullets:

- Given a situation, he must be able to analyze it with lucidity.
- He should be capable of conceiving, clearly and fast, the course to follow, and
- He must explain himself comprehensively to his fellow citizens, convincing them through his eloquence on the course he has chosen.

This is exactly what Franklin D. Roosevelt did when he took the reins of the United States at the depth of Depression. It is as well one of the best advice one can give or get. Though necessary, thinking of the unthinkable is not enough. It is also most important to study its aftereffects—from the most likely to those of remote probability but high impact. Not every statesman or corporate executive truly cares about the aftermath of his decisions prior to taking them. This *après moi le deluge* is:

- A frequent error in management, and
- It can prove very costly because decisions that are taken without deeper thought on their likely negatives often turn on their head.

Meyer Guggenheim provides an excellent example on how to look ahead of time at unwanted consequences. To renovate his company's management he made all his sons equal partners. This was criticized by some people who told him that a couple of his sons were too young to contribute their share. Yes, he answered, but when the elder sons who are now doing the work retire, the younger sons will take over. Besides: "Let us not forget the wives! If the wife of one partner hears that the partner-husband of another is making more money, trouble follows."[9]

Trouble also follows when the chief sees a catastrophe coming but does nothing to avert it. Examples of such chiefs are politicians who buy the hype that the banking industry can be self-regulated. Self-regulation of industry does not work even in the medium term without being watched over by a supervisor. Neither does the word of the regulator mean much if the law is not being enforced.

Each major undertaking is a project where nothing really reaches its end on its own accord. Hence the need for a roadmap after having studied alternatives, projecting the aftermath of each, and coming to a conclusion. Inevitably, the course that will be chosen takes into consideration not only financials and other resources, but also people who are able and willing to analyzing their behavior and motives, as Protagoras said in ancient times. This raises the questions:

- Which individuals have acted for which motives?
- What have they attained?
- What has been the cost of the deliverables?

Human behavior is always the critical link between cause and effect.[10] By carefully examining the events that have taken place since July 2007, when the most recent economic and financial crisis started, we can observe a slow decadence of the banking system that has not been reversed even if Western sovereigns have flooded the market (and the banks coffers) with money they themselves did not have. Pericles had already observed during his time that "everything in this world is destined to decline"—and in fact he even proved it by starting the Peloponnesian War.

In modern times the proof of banking decadence is the huge amount of toxic waste that has not been taken out of the banking system. Instead it continues accumulating with devastating effect on the Western economies. Its aftereffect might well be more powerful than that of the Peloponnesian War, in curbing the power of a till-then prosperous ancient Greece.

The massive numbers on exposure give vertigo. In mid-June 2010 a combined estimate by the US Senate and House of Representatives put the market value of derivatives alone at $1.2 quadrillion ($1,200,000,000,000,000) in notional principal amount. Demodulated to real money this is over $200 trillion in a worst-case scenario.[11] Or, roughly 14 times the gross domestic product of the United States.

- By majority this huge amount in practically useless paper has elected residence in the vaults of commercial and investments banks, and
- It has found its way into the holdings of central banks that accept it as collateral, further poisoning the Western economic system.

The huge exposure that is often assumed by commercial and investment banks in their effort to maximize returns without properly counting the risks, has led to an unprecedented amount of garbage that, by definition, is not being backed up by real results. This is the residue of instruments like collateralized mortgage obligations (CMOs), mortgage-backed securities (MBSs) based on subprimes and Alt-As, and other derivatives that have been part and parcel of the climax that led to the bankruptcy of AIG (salvaged through taxpayer money) and Lehman Brothers, among many others.

In America the most vulnerable of these "others" have been the mammoth government-backed mortgage corporations Fannie Mae and Freddie Mac, both of them practically bankrupt and taken over by the sovereign. By the end of March 2011, less than 30 months after the mortgage markets went into a tailspin, there has been a false sense of calm to a key part of the $14 trillion market of outstanding US home loans: Washington had guaranteed more than $5 trillion of mortgage-backed securities sold by the aforementioned government agencies.

Not everybody liked the fact that the so-called agency MBSs market has been supported for over two years by the presence of one and only huge buyer: the US taxpayer whose opinion was not even asked. Such purchases were part of quantitative easing (QE) and, according to the optimists, they played a vital role in stemming the effects of the financial crisis on the American economy. In the critics' opinion, the cost has been that of filling the vaults of the Fed with highly dubious "assets."

The pros said that by intervening in the agency MBS market the Fed kept alive mortgage finance. Otherwise the market for securities backed by private mortgages would have failed to revive. Critics answered that what has happened has very serious implications for the Fed and its prestige. While in all likelihood the Federal Reserve wants to return its balance sheet to holding only Treasuries by selling its mortgage holdings, this will not happen until the economy shows a sustainable recovery—which is not sure because, in the meantime, agency MBSs account for about half of its balance sheet.

The economy of not only the United States but also the whole wide world is sitting on trillions of mispriced financial instruments which have either turned to dust, or are not far from doing so. From investment and commercial banks to central banks, the financial system is heading for a state that:

- Totally escapes controllability, and
- Is difficult to prune and restore to sound functionality.

The fact that controllability became an illusion is a real and present danger to everyone. Nothing has been really learned from previous disasters and therefore they are repeated with greater frequency and impact. Fortunes on Wall Street and in all other financial centers rise and fall, but very little is learned from the twists of fortune because human memory is typically short. Misfortunes are soon forgotten, *as if* a permanent elixir has been found that eliminates all risk.

Successive financial crises bring risk back into the spotlight as trillions of dollars, pounds, euros, yen, and other currencies are lost. But, as Samuel Johnson and James Kwak suggest, big global banks act as an oligarchy.[12] The market goes into a tailspin and those who think they know better are very often the worse off even if theoretically they are pulled up from under because:

- They have used financial power to gain access to political power, and
- They have found the pathway of putting this political power to work for their own benefit.

Johnson and Kwak suggest that bankers achieved that status not through overt bribery but by means of soft power supported by large campaign finance contributions, the revolving doors of jobs on Wall Street and senior government posts, as well as the creation of a public culture that believes what is good for the banks is good for the country. This, they suggest, is the reason why Barack Obama chose the *blank cheque* strategy to deal with the financial crisis.

How long can this policy of the West's financial Peloponnesian War last? For how long will the taxpayers whose money is being used in "non-traditional" ways be left high and dry? The late 1920s/early 1930s provide an answer. Here is the way Nathan Miller expressed his understanding of Herbert Hoover's method to save the banks, insurance, and railroads while doing nothing to lift the common citizen from the misery of Depression.

> Americans were puzzled and then angered—that a president who handed out relief to corporations could ignore the misery of people grubbing in garbage cans for food. No leader who followed such a policy could maintain the confidence of the public.[13]

It was true in 1929–1932 and it was just as true following the crisis that started in 2007. Because of their one-sided attitude favoring the self-wounded big global banks rather than their own citizens, sovereigns have lost influence with their people—and, ironically, also with the banks. This has now reached a point that they cannot even assure compliance with Basel III, and they have been reduced to peddling the downsizing of its rules and regulations. One of the benefits of thinking the unthinkable is that finally more attention may be paid to the people than to the banks.

4. Competences and Incompetences of the Welfare State

Based on nineteenth-century theories that followed on the heels of the Industrial Revolution, the *welfare state* is widely considered to be one of the kids of socialism. Other inheritors of nineteenth-century thinking, which preceded it, have been communism in Soviet Russia, fascism in Italy, and nazism in Germany—three versions of *socialism-in-action* (SIA) that are by now extinct as political powers because of:

- Their insoluble systemic problems, and
- Their veering from dictatorship toward world conquest, which solidified the opposition to them.

While the welfare state, as we know it, appeared in a glittering manner after the end of World War II, it first assumed a low profile in the 1930s, infiltrating the Western democracies by capitalizing on the discrepancy in income and wealth—while after World War II it fed itself on the decline of military expenditures as well as on deficit financing. Having learned a lesson from the brutal course of communism, fascism, and nazism "SIA with a human face" chose a soft strategy, raising the proportion of spending on so-called social issues that:

- Have been ill-defined in their scope,
- Lacked the concept of limits, and
- Were way out of proportion with what an economy could afford and sustain.

Spending from a historical perspective, the welfare state's roots were planted some years prior to World War II in sequel to the economic crisis and unemployment caused by the 1929–1933 Great Depression. America passed its Social Security Act (mainly pensions) in 1935; France went for social security in 1936 and this included not only pensions but also state-paid health care and other goodies like an annual two-week vacation.

Britain got its inefficient and highly expensive National Health Service (NHS) with the Labor government right after World War II ended, as a sort of hybrid between state-sponsored welfare capitalism and a subvariety of socialism-in-action. At about the same time, promoted by Left-leaning popular vote, socialist parties in the Scandinavian countries began to develop a welfare system of their own that, by lasting till the end of the twentieth century, outlived communism in Russia by more than a decade.

"In France the promoters of socialism are superficial spirits," wrote Georges Pompidou, the late president of the French Republic. "They are in reality preoccupied not with the economy but with the redistribution of wealth, without paying attention to the creation of that wealth they want to redistribute. The socialist program calls for less work, higher salaries, greater retirement benefits and some nationalizations as a reminder to its anti-capitalist stand."[14]

In his book, Pompidou also brought into perspective that, as the Soviet experience has documented, the centralization of economic planning at the national level ("dirigisme") requires a political, administrative, and law enforcement (police) structure that is unwelcome in a country accustomed to individual freedoms, like France. He moreover points out that, as the same Soviet SIA example demonstrates, the net result is a considerable loss of productivity to say nothing about the inability to know the real costs.

By spending on welfare more than the economy could generate in wealth, socialism's inheritors confronted themselves with a mounting number of problems—problems which they were simply not fit to resolve. Neither are there any miracle solutions. The situation is reminiscent of the time of the Versailles Treaty, at the end of World War I, when John Maynard Keynes shook his head over the politicians' readiness to pursue victory in the battlefield without counting the financial costs and the damages these created to the economy (a position fully documented by the turbulent 1920s and its financial earthquakes that hit all Western economies, including those of the victors).

One of the ironies of the Great Depression that followed the unprecedented destruction of assets during World War I and the lust and greed of the 1920s, has been that by being excluded from the markets of the West, the Soviet Union avoided the aftereffects of the Great Depression. What it did not avoid was falling victim to its own systemic problems—precisely ivory-tower type decision making by the communist *nomenclatura* and bureaucratic degeneration that accompanied it. Here is how Eric Hobsbawm looked at one of its major and most glaring incidents:

> The Soviets, crude and inflexible, might by titanic efforts have managed to build the best economy of the 1890s vintage anywhere in the world…but what did it help the USSR that by the middle 1980s it produced 80 percent more steel, twice as much pig-iron and five times as many tractors than the USA, when it had failed to adapt to an economy that depended on silicon and software?[15]

This is one of the best-ever references to answer the rebound nineteenth-century socialism economists and their followers who (short of any other arguments) revolt against the "dictatorship of the market." True enough, the market does not provide a foolproof solution to economic problems but what are the alternatives? The one-track mind of *homo bureaucraticus* is much worse, and so are his social credentials. At the end of the day ivory-tower solutions lead to spoilage and economic despair as plenty of "socialism-in-action" experiences document.

Neither is deficit spending by the socialist nomenclatura the only wrong-way decision. There exist other biases as well. An example is the so-called *affirmative action*, a misnomer. What it stands for is giving preferential treatment in regard to some social activity or financial resource to a group of people. This is plain favoritism that might, only *might*, be acceptable on a very short-term basis, as a temporary measure to be phased out as soon as the existence of the handicap no longer creates a deep social bias.

- *If* affirmative action is extended over time,
- *Then* it becomes itself a bias destroying the social fabric and the fair playing ground.

Favoritism extended over a period of time to "this" or "that" social group brings about a great leap backward by damaging the sense of social justice in a wide sense, while making those benefiting from it lazy and unwilling to contribute their dues to society as they are waiting for manna from heaven. The clock is turning backward *as if* neither the politicians nor the voting public got the message of dramatic changes in the structure of "give-away" socialism. Wide-ranging failures of SIA have deprived nineteenth-century ideas of their original political hypothesis. Eric Hobsbawm had good reason for calling Chapter 16 of his book "End of Socialism."[16]

One of the ironies nowadays is that while communism has failed in Soviet Russia as well as in China (though it is alive and depressing the freedoms and well-being of people in North Korea), its hues and policies are being adopted by the welfare states. State supermarkets thrive in the formerly prosperous Western democracies on both sides of the North Atlantic.

Neither does it help to use the nineteenth-century bogeymen as a way to whip in line public opinion, making it subservient to socialist dogma, as theorists sometimes try to do. Take as an example *Fordism*, a term coined to identify the working of a mass-production plant built around the conveyor belt. In the nineteenth and twentieth centuries this had led to workplace and residential segregation, but that was the era that followed the Industrial Revolution characterized by its flourishing smoke-stack industries, which, in the course of the last three decades, have been in decline—even in extinction.

The problem today, so to speak, is the reverse. The disappearance of smoke-stacks in the West left as inheritance a poisonous residue of widespread unemployment. Unattended over a long period of time, since the late 1960s when Western governments decided that it is better to pay long-term unemployment benefits rather than train and retrain their human capital, long-term unemployment has become the most insidious, corroding, and perverse illness in the Western social structure.

Unemployment has joined overspending and rising illiteracy as an acute social disaster of that state of affairs that we call "Western civilization." Technology turned socialist dogma on its head. Instead of the old socialist dream of the industrial countries' populations proletarianized by more Fordism, the industrial working class dwindled as jobs disappeared. In the age of autos, the Internet, and social networks, the current salient problem in the West is not of "the class," but of self-confidence and self-consciousness. This is a virtue the fake money of the socialist state cannot buy.

5. Beware of Public Pronouncements about Controlling Deficits, Paying Entitlements, and Saving the Banks

The majority of economists and financial analysts are nonbelievers of the optimistic public pronouncements regarding economic growth, control of public deficits, or the early end of a financial and banking crisis. They know that public figures are characterized by a conflict of interest. In the US, Barack Obama, as president and commander in chief; Ben Bernanke as chairman of the Federal Reserve; and Timothy Geithner as president of the New York Fed, have usually been way too optimistic. European chiefs of state and their finance ministers have roughly taken the same road. Official optimism, however, did not change the underlying facts.

Rulers and potential rulers of a people and a state should have the brains to appreciate that money does not grow on trees. One must earn the money to spend. Prior to being elected president, but while governor of New York State, Franklin Roosevelt criticized Hoover's resort to deficit financing rather than following a pay-as-you-go policy. "This merely puts the burden on the unemployment cycle of future generations," Roosevelt told a correspondent of the press.[17]

After taking domicile in the White House, however, Roosevelt too adopted deficit financing. In the 1930s, this might have been necessary to pull the American economy out of the depression abyss. In a short span of one hundred days, Roosevelt enacted the Emergency Banking Act, Civilian Conservation Corp (CCC), Federal Emergency Relief Act, Tennessee Valley Authority (TVA), Home Owners' Loan Act, Emergency Road Transportation Act, Glass-Steagall Act (which includes the separation of commercial and investment banking, FDIC, and deposit insurance), National Recovery Administration (NRA), Agricultural Adjustment Act (AAA), and National Industrial Recovery Act (NIRA) among others.[18]

All this needed money, and deficit spending was seen as the way to give people hope and get them going again. Judging from the recovery that followed, the money was rather well spent. The downside has been that it created a culture of *entitlements*. Like *Chronos* of ancient mythology, over eight decades, entitlements devoured their kids. Foregoing their responsibilities, subsequent weak populist governments:

- Created the welfare state (section 4), which grew into a monster State Supermarket, and
- Killed the better parts of Roosevelt's legislation, like the Glass-Steagall Act.[19]

Let's face it. Politicians, particularly the socialist and populist lot, are quick in throwing other people's money to the four winds. They don't have in their mind the need for draconian spending cuts that would be necessary to pay-as-you-go, let alone to bring the budget back to surplus so that it can erase the accumulated toxic waste debt. Instead, they ring-fence their pork barrel.

No wonder therefore that as Simon Rosenberg, of the New Democratic Network, has pointed out, the idea that business as usual would result in a budget surplus comes from the "Harry Potter school of economics."[20] The public understands very well that politicians are insincere when they say that they will balance the budget and preserve the entitlements, but not everybody seems to have appreciated the deeper meaning of Rosenberg's reference.

Common citizens could be forgiven for forgetting that there is a close connection between spending and taxes. This is not true of governments, which should resist the temptation to feed the insatiable demand for "more public funds" by the State Supermarket. Spending is no more increasing linearly. It shoots up because of:

- Various economic stimuli,
- Bank bailouts, and
- A stagnant or reduced gross domestic product.

Governments allow even obsolete expense chapters to keep on running their course, without explaining to their citizens that—whether through inflation or taxation—they will pay for them in the coming years, all the way to the coming generation. Neither do the politicians acknowledge that the economy is in for a long, slow haul and there are going to be unavoidably negative consequences.

The political debate is more about "taxing the rich" and assigning blame left and right for the deep recession, than about suggesting imaginative ways to come up from under. Instead of focusing attention on expenses, the economic and banking crisis, which started in 2007, inaugurated a new era in state activism, consequently further weakening public finances.

In an environment where the worst continues worsening, anything that has already happened is likely not only to reappear but also to do so on a larger scale. Some analysts used the arithmetic of US public debt for evidence that sovereign debt crises could spread far beyond Greece, as other sovereign defaults or near-defaults may follow.[21] Different studies have documented that:

- Public debt tends to soar after financial crises, rising quite significantly in real terms.

When this happens, worries about where a new growth impetus will come from become widespread. Is Italy, or Spain, or Portugal, or France the next in line for default? In late February 2010 George Papaconstantinou, Greece's finance minister, remarked: "People think we are in a terrible mess. And we are."[22] This can be stated, as well, of other western countries.

In the US, entitlements represent 60 percent of the budget, and are its fastest growing part,[23] to which has been added the silly salvage of the banking industry. *If* the economy was to take off and grow at, say, 10 percent per year, as the case used to be in China, *then* the budget deficits will be less of a problem and there may even be a surplus. (In the US this has happened in the late 1990s when the boom in the stock market brought to the government a windfall of revenues.) A 10 percent growth, however, is not the way to bet.

- Because the West is most exposed to the aftereffect of the banking crisis, the term "rich country" is a misnomer.

Today, no Western country really has a sustainable debt position or is growing quickly enough to stop its debt burden from rising. While by all evidence the worst offenders can be found among Euroland's peripheral economies, America and France are not that far behind, considering the scale of their budget deficit and rather bleak growth prospects.

All over the Western economy, the sorry state of government finances may destroy practically single-handed the regulations promoted by

Basel III. It has already tuned down the rigor with which supervisory authorities look at the observance of the new rules by individual banks under their remit. This leads to funny contradictions. On March 10, 2011, France and Germany asked, on one hand, that Basel's capital rules be observed, and, on the other, that their implementation be delayed.[24]

The banking crisis has come at the worst possible time when governments have been confronted by the hard task of coping with entitlements and the other goodies the State Supermarket promised to deliver. The intervening banking earthquake made the commitments taken on by sovereigns even more unaffordable and unsustainable.

In the fiscal year that ended on September 30, 2010, America's budget was $1.3 trillion, or 9 percent of GDP. This was the second-largest ever budget in peacetime. The biggest one, in 2009, was also under the watch of Barack Obama and his administration. As far as the US taxpayer is concerned, over and above Federal taxes come:

- State and local government borrowing,
- Indebtedness of government-sponsored agencies (hence still in the public sector),
- Indebtedness of banks and other companies in the private sector financed by the common purse, and
- Indebtedness of individuals and households, which is by itself in excess of 110 percent of the US GDP.

So many groups of borrowers have been addressing themselves to the market at the same time that they crowd out each other. If it were not for official policy, rock-bottom interest rates would have been zooming. But how long can this last? Will banks be able to attract capital for their contingent convertible instruments? At what price?

Rising health care costs and other demands by an aging population increase public spending and negatively affect the rate of growth. Zooming commodity prices make even an anemic 2 percent annual growth in Western countries look like an overstatement. The political fortunes of incumbent governments depend on these statistics and projections. To those who hold the reins of power, paying entitlements and saving the banks would be worth nothing if their party were voted out by an angry electorate (as it has happened in Ireland in early March 2011, precisely because of throwing an incredible amount of public money in one ill-studied move: the salvage of the self-wounded Irish banks).

Whether through debt or through poorly defined assets, no economy can expand forever. Eventually comes the day of truth and there is no point in trying to emulate the missing rate of growth through cheap methods like dramatically increasing the rate of printing paper money. Theoretically, this makes an otherwise nearly bankrupt government look *as if* it could pay its dues rather than having to declare bankruptcy. Practically, that sort of creditworthiness is a fata morgana; it only delays the day of reckoning.

The policy of quantitative easing (QE) has been tried by Ben Bernanke with very limited success. Even that is an overstatement because the economic situation in the United States has not become appreciably better because of it. Realizing that there exist also limits to QE, the Fed announced "tapering," which essentially meant a shift to buying short-term debt. But by June 2014 the printing presses were still producing $60 billion of new money per month with the result that:

- The economy turned into a new money addict, and
- Labor's participation rate dropped to its lowest level since 1978.

Every single day and every single hour, including nighttime, the US government has been spending $200 million it does not possess. The final solution has been an unprecedented amount of money printing, which can, under no account, last forever. At least the European Central Bank learned a lesson from QE's failure, but the alternative it announced on June 5, 2014, is far from being a guaranty for success (section 6).

6. Can the European Central Bank Battle the Deflation Dragon?

In early 2010 a status of near-bankruptcy hit the Greek economy while Italy, Spain, Portugal, and Ireland also found themselves at the edge of the precipice. This led to an acute Euroland crisis, with the very survival of the single currency being in doubt. By June 2014, four and a half years down the line, and at the time of writing, Euroland continued to be besieged by chronic economic problems.

- Growth is sluggish,
- The bank's don't lend,
- Business confidence is far from being stellar, and
- A low inflation (at 0.5 percent) increases the danger of a Japanese-style deflationary spiral.

As if all this was not enough, in many EU member states unemployment remains at record highs, fueling public disillusion with the status quo and pressing for measures to be taken by the ECB. On June 5, 2014, the European Central Bank responded with a multipronged package, but economists doubt that this is going to tip the scales.

The ECB announcement cut interest rates to a record level, bringing one benchmark rate below zero; applied a minimal negative interest on commercial bank deposits; extended the long-term refinancing operation (LTRO) into targeted longer-term refinancing operation (TLTRO); brought an end to the "sterilization" policy; promoted the purchase of asset-backed securities but without specifying how much garbage will be acceptable; and advanced a €400 billion ($544 billion) program that offers cheaper long-term loans to banks on condition that they lend to companies.

Euroland's bank lending is indeed at rock bottom. While banks try to keep money close to their chest, never being done with rebuilding their balance sheet, this is not the only reason why lending has tanked. Most industrial and merchandizing companies simply don't need more money than they already have. With business confidence having taken a leave, investments are at a low point. Moreover, all counted, potential borrowers are in a better financial condition than the lenders.

There exist, of course, in Euroland companies starving for money, but they are not creditworthy. Hence banks will not lend them money. Loans can turn sour even in a healthy economic environment, but these typically represent 2 percent to 3 percent of lending. Market sources suggest that bad loans are in excess of 10 percent in Italy (in some cases in excess of 15 percent) and to avoid bankruptcy banks capitalize the interest. They are increasing the amount of the loan in the banking book but are giving no liquid money to the borrower.

Italian banks are at the eye of the storm. They have €160 billion in nonperforming loans (the aforementioned 10 percent of all loans), and have taken more than their share of the €45 billion capital raised in the first half of 2014 in connection with the Asset Quality Review (AQR).

What will the ECB do? Buy all the bad assets directly through the chemistry of useless ABSs, poisoning its portfolio because of the unprecedented amount of toxic waste? The June 5, 2014, ECB measures are not going to correct this weakness though they could worsen the overall situation because of the major unknown about what is hiding under the ABSs the ECB plans to buy. Critics say that behind this nearly indiscriminate ABS business hide:

- Inefficiency, and
- Absence of business ethics.

Euroland's banks are still borrowing €651 billion from the long-term refinancing operation or Main Refinancing Options (MRO), so while a 10 basis points (bps) cut in the deposit rate will cost them €116 million annually, a simultaneous 10 bps cut in the refinancing rate will save them

€651 million per year, reduced borrowing costs on the floating-rate LTRO and MRO. Still, there will be winners and losers since Euroland's banking system consists of net borrowers from the ECB, like Italy and Spain, who will benefit, and net depositors at the ECB,like Germany, Holland, and partly France, who will suffer.[25]

As for the ECB's TLTRO, given the attached lending requirement, many economists consider it as a near copy of the Bank of England's Funding for Lending Scheme. The sense of it is that the central bank tries to promote the lending trade. It will buy securities backed by private sector loans and there will be cessation of a "sterilization" exercise, which has (at least theoretically) dampened the monetary effect of the ECB's purchases of government bonds.

The TLTROs will have an initial targeted amount of €400 billion in 2014, be endowed with a very low and fixed interest rate (main refinancing rate at the time of the tender plus 0.10 percent), and run until September 2018. It will be accessible on a quarterly basis from September 2014 to June 2016, with the option of repayment after 24 months. It is not clear whether:

- These provisions will limit the amount banks draw from the TLTRO to new loans to nonfinancial corporations only, or
- They will also permit banks to substitute more expensive funding with this very cheap financing channel.

The ECB is right when it tries to ensure that the supply of credit to nonfinancial corporations neither endangers recoverynor increases the distortions in the monetary transmission channel. The ECB alone, however, will not change the currently prevailing economic crisis.

As for the sterilization of the securities market program that will be suspended, experts believe that this is equivalent to a liquidity injection of €165 billion. Over and above that, the collateral framework has been eased by extending the admission of special assets such as credit claims (until September 2018).

Many financial experts dispute the wisdom of the other measure in the June 5, 2014, ECB package: the negative interest rate of 0.10 percent to be paid by banks depositing funds to the central bank. They look at it as a compromise between doing nothing and doing something in the most limited way possible, since its aftereffects are unknown.

Theoretically, this negative interest rate was intended to induce banks into lending. Practically, as with so many other measures, such an idea may be wishful thinking. As it has been already explained, a lack of demand for loans limits their effectiveness while it may induce banks into gambling with derivatives and other risky instruments.

Economists have also criticized ECB's decision to keep interest rates at rock bottom in the longer term. An increase in interest rates might have seismic effects on countries overburdened with public debt like Italy and France, but it is a cheating of both the institutional investors and the general public. The ECB is creating "increasingly dangerous side effects," said Georg Fahrenschon, head of the association that represents 418 Sparkassen (savings banks) across Germany. "Instead of the hope for boost to the economies of the crisis-hit countries, savers across Europe will be further alienated and asset values will be destroyed through the new interest rate cuts."[26]

Responding to a specific question about its impact on savers, Mario Draghi, the ECB president, said the rates were for banks, not for people, suggesting that as the economy grew, interest rates for savers would rise. This is, of course, a way of talking. Draghi and other central bankers know it is not going to happen if the ECB does "what it takes" to keep interest rates from rising. Thinking the unthinkable, savers are going to be hard hit over a longer period of time. No matter how one looks at the ECB's June 5, 2014, package, those who are working and saving are penalized while the profligates are rewarded. As for the central bankers, the implementation of these measures is not going to be a walk in the park.

7. Thinking of the Unthinkable before Adversity Hits

Because the most basic aim of politicians is to get reelected, it is understandable that they are eager to know about projected economic developments. This is a sound policy, but not a sure winner because so much depends on economic recovery that may be beyond reach because past decisions backfired or the debt burden is too heavy. Quite often what the politicians learn is not what they want to hear.

Concerned about his reelection in 2012, in early 2009 Nicolas Sarkozy, the then president of the French Republic, asked the country's economists for a projection on the end of the ongoing economic crisis. The answers that he got made no happy reading, with opinions provided by the experts falling into three groups:

- The *optimists* said that some improvement would start "next year," but its effects would only be felt in 2013.
- The *pessimists* answered that the year the economy would take off again is further out, probably 2015 or beyond.

- According to the so-called *catastrophists* the worse was still to come, with the prognosis being that nobody would escape the economic cataclysm.[27]

The French economists also pointed out that a great deal associated with the likelihood of each of these scenarios would depend on the success or failure of Timothy Geithner's Public-Private Investment Program (PPIP), a US initiative (which eventually led nowhere). This was stated not only in regard to whether private capital will participate in lifting the French economy, but also in connection with the banks' willingness to sell their toxic assets at rock-bottom prices.

The unanswered question at that time (2009) was whether PPIP will be able to clean up all of the zombie banks toxic waste. It did not. Five years down the line from that projection it was no secret that the PPIP was a failure. Capitalists came forward with billions, but before putting it on the table they made it clear that they would not pay more than a one-digit number of cents to the dollar for the banks' toxic assets. Banks did not wish to sell their toxic assets at such a deep discount. They chose to keep for themselves what they had not unloaded to the central bank's coffers in exchange for cash.

It might sound funny but, as far as political decisions were concerned, turning cash into trash became a favored use of public money. It did appreciably diminish the wall of worry surrounding the finances of big global banks, and it improved their reported earnings but the euphoria did not last long—at least among credit institutions. On the contrary, the banks' clients and the general public found themselves in a financial condition leading to a bifurcation.

- Companies other than financials have been doing well.
- But the economy as a whole and the citizens were in weak condition.

In 2010, for example, earnings per share (EPS) in the manufacturing industry outpaced almost all expectations, producing a V-shaped corporate profits recovery. But employment opportunities did not follow in EPS's steps because earnings growth was driven by cost cutting. As sales rebounded:

- Only a quarter of projected employment opportunities materialized, which was too little for comfort.

In 2009 in the United States, for example, industrial productivity rose at an impressive annualized rate of over 4 percent while hourly compensation crept ahead by just 2 percent, with the result that unit labor costs fell by 2 percent. This was the steepest cumulative decline in cost figures since the 1950s.

- By contrast, in the banking industry, bonuses for top executives and traders have been on their way to reaching their previous highs.

This overpay of employees in the financial sector not only contrasted dramatically with the general trend in the Western economy, but also demonstrated another aspect of loose supervision of the banking industry (which in several cases merged with conflicts of interest). Among others Josef Stiglitz, of Columbia University, brought attention to the market imperfections and misaligned incentives that distorted decisions made from mortgage originators to credit rating agencies.

Stiglitz's criticisms of the flawed policy response ranged from economic decisions (for instance, that Obama's team failed to draw on theory, empirical evidence, and common sense) to the bank rescue plan, which he described as among the most costly mistakes of any government at any time. Part of the problem, Stiglitz said, is that regulation lost influence as regulators are not immune to hire and fire by presidents.

1. George W. Bush fired his former friend William Donaldson after the latter voted with two SEC commissioners to regulate hedge funds.

Yet, Donaldson was right. *If* hedge funds are not regulated, as is the usual case today, *then* the banking industry is not regulated either. It is nobody's secret that practically all big global banks have under their wings a swarm of hedge funds and unregulated special investment vehicles so that they can do as they please. It seems unthinkable but it is true.

It could also be reasonably argued that hedge funds have been the unintended result of regulations. To a large part, they owe their ability to go short and make money even in falling markets by devising different strategies that allow them to go around obstacles—something that licensed banks cannot do. This is not fair play; neither is it the only unexpected consequence of dents in prudential supervision.

To ensure that banks have enough capital to cope with economic crises, Basel II created incentives to hold AAA-rated securities, requiring less capital to be held against them. This gave birth to fake AAAs: the swarm of collateralized debt obligations (CDOs) and other instruments that were junk but christened as AAAs by the rating agencies.

2. Barack Obama twisted the hand of the Financial Accounting Standards Board (FASB) to largely cancel the marking-to-market

> rule, so that the banks don't have to mark down the toxic assets in their portfolio.

That is creative accounting, officialized by the sovereign. Even Henry VIII did not take the road of such a conflict of interest at the time of the South Sea Bubble. The logic behind it is unthinkable, but not impossible. When the market goes up banks mark-to-market their securities, showing big profits and paying huge bonuses. When prices fall, they can only show historical values that mean nothing.

It looks as if the sovereigns like the crooked deals, as most evidently this is not serious business. Under conditions of very favorable treatment of a protected species, bank supervision becomes a joke, and the economy is weakened. Sovereign favoritism is naturally welcome by the big players of the financial system.

It serves preciously little to have laws on bank supervision when politicians are allowed to turn the tables on regulators and laws are not enforced. According to expert opinions, the nature and quality of regulations was not the root cause of the fate suffered by AIG, but rather the way these regulations were executed. This should be accounted for in current efforts to restructure central bank frameworks like the ECB example discussed in section 6.

Political interference weakens even the best-studied laws and rules, opening the gates to a swarm of moral hazards. In an interview he gave to Charlie Rose on December 7, 2010, on *Bloomberg News*, David Einhorn pressed the point that as a bank supervisor and regulator the US government did a very poor job. The regulators were not up to their responsibilities and the same is true of credit rating agencies and the media.

It has been a failure of the gatekeepers, Einhorn said. Even after the weaknesses were identified in the case of Enron, the law was not enforced. There was hardly any prosecution. Along with politicians those responsible for law enforcement provided cover. Ethics aside, the government's involvement in the way the market works saw to it that US policy got unstuck from the characteristics of a free market. Einhorn is right in these statements.

Belatedly, after heaven has broken loose, some sovereigns try to restructure the regulatory framework or at least study what has gone wrong and what needs to be done. Britain, home of 5 of the world's 30 biggest banks, set up a commission to review the structure of banking. In late January 2011 John Vickers, the commission's chairman, gave a speech outlining his thinking, saying that banks should guard against future catastrophes by raising more capital while retail banking operations should be legally ring-fenced from investment banking.

The Vickers commission has taken thousands of pages of submissions, largely from banks, and held hundreds of meetings with them as well as with investors and other stakeholders. Its work has been productive but the key issue of separating commercial banking from investment banking was put in the time closet. Still, as *The Economist* wrote: "The home of light-touch supervision now fancies itself as the abattoir of too-big-to-fail finance."[28]

Along the same principle of thinking about the unthinkable before adversity hits the European Commission, too, proposed reform of the banking industry, drafted in 2012 by the Liikanen Committee. What the EU Commission proposed is the inverse of the Vickers conclusion: to ring-fence the proprietary trading activities that involve taking risks with the banks' own money from the rest of financial institutions' operations.

Those who have been against this solution said that the EU plan is redundant now that the German, French, Italian, and Belgian governments have opted for their own proprietary trading bans, similar to the Volcker rule in the United States. This is only half true, the proof being that BNP Paribas, the largest French bank, put its US retail networks, Bank of the West and First Hawaiian Bank, under the same holding company as its investment banking and asset management arms, though they will operate as separate units making it difficult to move liquidity and capital between those companies. (The Ukraine crisis has been another potential problem for BNP Paribas, which has a retail bank in the country: UkrSibbank, with 550 branches.[29])

In addition, big legacy residues remain in the form of huge debt loads given to uncompetitive economies, while high levels of unemployment still dominate. Across Western economies debts stand at postwar highs, constraining recovery, blunting monetary expansion, and limiting the political appeal of fiscal stimulus, with economic weaknesses turning the European periphery's woes into one of the most miserable pictures in modern economic history. As of June 2014, this is a scenario with no clear end.

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6

Ethics and Efficiency in the Financial Industry

1. Ivar Kreuger and the Industrialization of Leverage

Ivar Kreuger started his career as a builder. At a time when no other entrepreneur would undertake to construct a house or factory in the cold climate of northern Sweden in winter, Kreuger made his mark by putting in place a wooden structure bigger than the projected construct so that men and materials would be in a protected environment. Then, having made a name as an engineer, he turned his attention and his imagination to finance.

Kreuger's industrialization of financial leverage was a product of his time. The decade of the Roaring Twenties had created an environment that set aside ethics. Investors and speculators were ready to absorb new financial products and processes that promised a big fortune quickly. The keyword was "more."

The man who ended his life in the wake of one of the biggest financial scandals of the twentieth century did not start as a Ponzi game crook as some of his biographers suggest, though he did go for high stakes. Right after he obtained a degree in engineering he sailed aboard a liner into New York where he could sense the mood of euphoria beginning to grip Wall Street. By taking advantage of it:

- He helped define his era that turned medium net worth individuals into investors, and
- Used the laissez-faire spirit of the time to persuade cash-strapped European governments to grant him monopolies.

There were match monopolies on which he built a name and a fortune. The Swedish safety match spread like a hotcake earning him the nickname: the Match King. Other big deals followed with every product Kreuger dealt with and leveraged to the limit. To his misfortune, till the day of reckoning there were always takers.

The movement of capital was already rolling and shaking the Western world since the late nineteenth century, and it accelerated prior to World War I. Sweden was a country that sat on large forestry and mineral assets waiting to be exploited. International capital helped in financing Swedish factories, and inventions added a special appeal. The safety match, as we know it, became a hit after a Swedish professor developed a nontoxic type of phosphorous.

Ivar Kreuger's father owned two match factories but the young engineering graduate did not immediately see the matches' potential. Instead, at age 22, he went to New York, where he found a job in building the Plaza Hotel and other landmarks. Back in Sweden he applied what he had learned about new construction techniques.

The Kreuger & Toll partnership gained a reputation as a construction firm, built Sweden's first skyscraper, and went public. Expanding his business horizon and backed by three Swedish banks, Ivar Kreuger took over his father's match business, founded the Swedish Match Company, and with this he started his reign as one of the world's great monopolists. Critics say that Kreuger's ingenuity lit a fire of speculative excesses around the world creating, then burning through fortunes.

Bastion after bastion was built followed by an increasing amount of leverage mixed with inventions from *absurdistan*—the public administration's stuff. As the financial empire expanded, its marketing arm included peddlers of stocks in imaginary mines, mutual fund managers whose imagination was unconstrained by integrity, and many more revered speculators of the banking industry whose genius lay in studying and applying practices and feasts prior to and after the South Sea bubble (chapter 4).

The pros say that during his early career Ivar Kreuger's decisions and acts were characterized by his attempts to combat the despair of his times by channeling money from rich nations to impoverished ones. True enough this had earned him admirers nearly everywhere and in some quarters he was seen as a "force for good" crushed by the bleakness of his era.

Kreuger's rise and fall, as well as his speculative excesses, are a lesson in the dangers of excessive confidence and luck of liquidity—both as relevant today as they were in the 1920s. John Kenneth Galbraith, the economist, put it right when he said that the principle in the financial world that everything depends on business confidence is a dangerous cliché. A better principle is that of unremitting suspicion.

Kreuger capitalized on the fact that because it required little capital to run small match factories that made just enough money to survive there was a proliferation of such outfits throughout Europe. By majority, they were run in an inefficient manner. His vision was to consolidate them in a way that served two complementary objectives:

- Make him very rich, and
- Gain power by way of recapitalizing Europe's shattered post–World War I economies.

After acquiring factories around the continent, in the early 1920s, from 1925 onward Kreuger began offering a bargain to penniless governments that many found hard to refuse. He would lend the governments money provided they allowed him to have a national monopoly on match production. Governments taxed matches and Kreuger's hypothesis was that hard sales would lead to higher income for the monopoly as well as raise the sovereign's tax revenues to service and repay the loans.

The granting of monopolies by the European governments was financed by American investors. Ivar Kreuger had a genius for financial innovation accompanied by an utter disregard for proper accounting, making him a forefather of the creative accounting practices that flourish today (section 4). Then, as now, investors did not care much about the absence of transparency as long as profits, good profits, kept coming in.

During the 1920s Swedish Match struck such deals with nine European and three South American countries. The loans totaled $253 million, big money at the time. Germany received $125 million; France (which never granted a full monopoly) $70 million. In 1930 Kreuger sent an emissary from his New York broker to China to persuade the Chiang Kai-shek government to give it a monopoly.

Harry Truman called the corrupt Chinese leader "generalissimo cash my check."[1] He was always ready to make a financial deal and his response was positive, but in the end Kreuger doubted Kuomintang's ability to guarantee a monopoly and called off the talks. This is proof that in his years of wheeling and dealing Kreuger was prudent, but eventually his judgment was biased by the high leveraging he needed to continue benefiting from American capital.

Unavoidably a greedy speculative spirit came along with it. It was only normal the funds came from the US. World War I had enriched America and impoverished Europe. The US government was loath to finance the reconstruction of the Old Continent, but on Wall Street, when Kreuger came knocking, the doors opened wide.

Not only Ivar Kreuger but also other financiers hooked investors with a cocktail of rising dividends and tax-exempt foreign earnings. After he set up the International Match Company in New York in 1923 the Swedish businessman raised an estimated $150 million from American investors. The money was transferred abroad to finance government loans as well as for the expansion of the match empire.

Eventually it turned out that match monopolies were not all that profitable. To offer spectacular returns, Kreuger paid dividends out of capital, not out of earnings. He also went ahead inventing fake monopoly agreements to keep his myth going. There is nothing unusual about this when it comes to speculative investments.

By late 1931 according to rumors, financial troubles were around the corner. He found it difficult to ensure his company's dividend payments, which endangered the bedrock of his cash hoard. And while his principle was "silence and more silence" his bank creditors insisted that they are not as completely informed about his operations as they should be. The bankers wanted to know what lay behind the touted real estate investments outside Sweden and other deals involving industrial shares.

Kreuger had also made an enemy of the House of Morgan when he interfered with its global finance operations. That caused him consternation. Relations with the Morgan Bank deteriorated rapidly. When he made his $70 million loan to the French government. Till then, the international media had compared him to the Medicis and Fuggers, history's other great private funders of governments.

After Ivar Kreuger's suicide (more on this later) details emerged of assets inflated by double counting along with a forgery in Kreuger's hand of $142 million of Italian bonds supposedly sold to him by Benito Mussolini. With more revelations hitting the news, it was eventually found that Kreuger's businesses owed more than Sweden's national debt. In America shares of his international holding company collapsed, wiping out the life savings of thousands.

It took five years for investigators to disentangle the accounts of Kreuger's 400 companies. In a career that spanned merely 15 years he was estimated to have burned through about $400 million of his investors' money. Moreover, when Kreuger's suicide was reported in March 1932, it was discovered that he had forged holdings of Italian treasury bills. His empire collapsed but some of the businesses he founded or invested in survived. Swedish Match and Ericsson are examples.

The end revealed plenty of bogus dealings and make-believe "assets." It worked the way the North Koreans are specializing these days in their public relations showing on television—children with plump, rosy cheeks singing hymns to the Motherland—while it would have been more truthful to show them in rags and starving.

Indeed the North Koreans must have learned a lot from Kreuger and other promoters of financial garbage, for instance, the subprimes. According to the fake communist regime's media, when he was still a baby, the late Kim Job II, son of Kim Il Sung (the first North Korean dictator), learned to walk in three weeks and to talk in eight; he also wrote six operas and 1,500 books while a student at Kim Il Sung University, and scored five holes in one in his first game of golf.[2]

Both the Kreuger reference and that of the Kim offer lessons in ethics and in efficiency. Today's financial world needs them because the big lies are alive and well, while the global economy resembles the era of rootless, transoceanic finance that Kreuger entered when he first arrived in New York. Now as then:

- Credit has ballooned,
- Paper money is being printed in unprecedented quantities,
- Capital travels around the world faster than any human being can,
- Greed is supreme, and
- Audacity with the design and marketing of financial instruments is unprecedented.

New legislation has not changed human nature, neither could it have been expected to do so. After the "Kreuger crash" shook Wall Street, America's Securities Act was passed in 1933 strengthening disclosure requirements for all companies selling stock. *If* this had been effective, we would not have had the cases of Enron, WorldCom, and so many others.

Postscriptum— with his optimism Ivar Kreuger could sway bankers' opinion and turn a bad situation to his advantage. This, however, did not always work. Pressed for money a short time prior to his suicide he met Dr. Robert Lehman, of Lehman Brothers, to ask for a loan. Lehman asked him detailed questions and took careful notes during the businessman's presentation.

Ivar Kreuger narrated his story about match monopolies and how with the loan he would acquire more of them, and so on and so forth. When he finished Lehman asked for some time to study his notes, retiring to his private quarters. Back in the bank's office, Kreuger, who had waited, hopeful he had impressed upon the banker the wisdom of the loan, asked for his decision; Lehman replied: I always have the policy to study my notes, and if I cannot understand what I have written I never loan money. That was the final call.

2. What the Public Should Know about Banking and Bankers

There is no doubt that banks play a useful role through their core activities of the payment system, deposit taking, and loans. This cannot be said about speculation and the creation of new money at the level of commercial banks. There is practically no limit to the creation of new funds by commercial banks, said Marriner Eccles, chairman of the Federal Reserve in the Roosevelt years.[3]

According to the pros, if banks did not enjoy this extraordinary privilege, it is doubtful whether they would have at their disposal the quantity of profits that makes high salaries and rich bonuses possible. Yet, the public is largely unaware of how the banking system works. It is widely believed that all money is created by the state or the central bank (which is partly true), and not by the profit-making private banking industry. The difference between the two modes is significant.

The freedom to engage in money creation and (associated) trading activities, including securitization, are two of the basic reasons why bank supervision has to be steady, analytical, and biting. When malfunctions are uncovered, let alone swindles, the bankers' personal responsibility should be directly engaged. The crisis of 2007, which sent the economy reeling, came about because bankers gambled while supervisors and chiefs of state miscalculated, foregoing their duties.

The third reason underpinning the need of a well-focused supervision is the rapidly growing size of the banks themselves including the risk this poses to the economy and to society at large. The more the number of banks shrinks, wiping out the capitalist principle of competition, the greater becomes the impact of the large and complex banking groups (LCBGs).

Andrew Haldane, of the Bank of England, has compared the rush of banks to gain size to elephant seals that maximize their own success at the expense of other species. From July–August 2007, when the never-ending current economic and banking crisis started, two things have been evident.

- Commercial and investment banks definitely need reform and better supervision, and
- Left to their own devices banks are incapable of reforming themselves. They have to be reformed from the outside.

This is not appreciated in financial circles. The response of many banks to overdue new regulations is to use their lobbyists to protect the status quo. The lobbyists also complain that their clients can no longer make decent profits, and therefore they are not able to lend despite the massive amount of funds they are getting from central banks.

In reality, they are using the central bank money to restructure their balance sheets, which, in the aftermath of the 2007 economic and financial crisis, were revealed to be awfully weak. Many have not yet recovered. Equity plus Tier 1 and Tier 2 capital (T2 is sometimes of questionable value) are way below the level required by Basel III.[4] They are even below the 8 percent threshold for international banks under the now-obsolete Basel II.[5]

Instead of being properly capitalized and equipped with enough liquidity, all over the Western world the banking industry is highly leveraged, not well supervised, and trades in all sorts of shady deals. Neither has there been a real change from the old cozy government–big bank deadly embrace. Instead, old gimmicks continue unabated, like the so-called *double leverage*, a financial technique that makes it impossible to solve a bank's debt problem by selling healthy assets.

Even Basel III has been watered down due to fierce opposition not only by banks but also by governments. Delays in its implementation and easing of rules and regulations left lots of loose ends. The aftereffect is that both:

- Ethics, and
- Efficiency suffer.

At its roots, this is a political and a governance problem. At the junction of sovereign and general public interests is a small in-crowd that has too narrow a vision of the world, even if it is characterized by global ambitions. Inherent to it is a model of conflict resolution that, by its very nature, cannot go too far.

Oversights and scandals are therefore unavoidable, and from time to time a scapegoat is found. Rajat Gupta has been one of America's financial elite. He was a senior member of Goldman Sachs and Procter & Gamble. For years he led McKinsey, the consultancy, and when he was secretary-general of the United Nations, Kofi Annan made Gupta his special adviser for management reform.

According to regulators, Rajat Gupta allegedly passed confidential information to Raj Rajaratnam, a hedge fund manager sentenced on October 13, 2011, to 11 years in jail.[6] This was a case of ethics and of violation of the law. Other senior people, however, simply open their golden parachutes. There are no prison terms even if they have been accused of ethical violations and high inefficiency. ING, the big Dutch banking and insurance conglomerate, proved to be:

- A poorly managed holding company,
- Exhibiting little cohesion between its various divisions,
- Characterized by low-quality governance,
- Employing an overpaid rather unproductive staff, and
- Showing little interest in risk control.

After the collapse of Lehman Brothers, the Dutch sovereign used plenty of taxpayer money in pulling ING out of the abyss. There was no investigation of personal responsibilities and no penalties.

The same story was repeated in February 2013 when the Dutch sovereign nationalized the lender SNS Reaal. The stakes of shareholders and bondholders were wiped out, but nobody prosecuted the bank's CEO for inefficiency and mismanagement. Only the former director of the property finance unit that brought down SNS Reaal was arrested on suspicion of fraud.

The Dutch central bank has been criticized twice in connection with this affair: for approving SNS Reaal's acquisition of a property business in 2006, despite worries that its balance sheet was too big for the bank to handle, and for failing to step in sooner to shut it down. For the sovereign that was already water under the bridge; the common citizen, however, remembered it as a double standard.

For many the SNS Reaal nationalization was a reminder of the 2008 collapse of ABN Amro, a former LCBG that required more than €17 billion from the government when its short-lived takeover by Santander, Fortis, and the Royal Bank of Scotland (RBS) came apart during the crisis. In addition, losses from ABN Amro's trading book, which stayed with RBS after the demerger, were blamed for the British bank's failure in 2009. As for Fortis, weakened by its part in this poorly planned and ill-fated acquisition of ABN Amro as well as by substandard governance, the Belgian-Dutch group received a government bailout.

In October 2008, Fortis agreed to let the Dutch government nationalize all its operations in the Netherlands at a price of €16.8 billion (then $21.7 billion). This left the Belgian state with the task of taking over Fortis Bank Belgium and finding a buyer for it. The buyer was BNP Paribas.

The political and financial problems that subsequently surfaced had their origin in the fact that the bankrupt big bank failed to seek shareholder approval for any of those transactions. Equity holders successfully sued Fortis, resulting in a Belgian government crisis and adding to the uncertainty about the future course. On February 11, 2009, a court-mandated meeting put the above transactions to separate votes.

Shareholders voted "No!" to these deals. But since the Dutch nationalization and Belgian part-nationalization had already been completed, the "No!" votes merely opened the door for further mitigation rather than serving to reverse the processes. Central to this problem was the fact that while the deals made in October 2008 averted a run on the bank in either country, they left shareholders owning a much diminished company with a share price that at one point sank below €1 compared to more than €30 in early 2007.

Shareholders, many of them retail investors, but also Ping An, a big Chinese insurance company that owned 6 percent of equity, felt they had little left to lose. Ping An appeared to have been angered by being frozen out of the renegotiation, though its decision to vote against the Belgian government's October 2008 salvage plan followed a renegotiation of the transaction between BNP, the Belgian state, and Fortis.

Neither in the case of Fortis nor in that of RBS nor of any other collapsing banking conglomerate was top management held responsible for the disaster. Instead, shame was used as a sanction. "Sir" Fred Goodwin's reputation was already in a shambles following the failure of the Royal Bank of Scotland and a nasty public row over his pension. Then, on January 31, 2012, the Honors Forfeiture Committee ruled that "Sir Fred," as he has been known since 2004, should be stripped of his knighthood after his tenure as chief executive of RBS ended ignominiously with a huge bailout.[7]

The irony is that Goodwin had received the knighthood from the queen precisely for the role he played in RBS's rise to glory six years earlier but this, too, was water under the bridge. Still another irony is that the Royal Bank of Scotland, with the government's share at 82 percent, lost $3 billion in 2011 but still paid $600 million for bonuses (albeit reduced by 26 percent versus 2010).[8] Not to be left behind, Crédit Agricole, a French bank, also lost $3 billion in 2011. The top management had failed in its duties, but it did not fail to pay fat bonuses to those who lost the bank's money. Congratulations.

3. Demonology and Highly Risky "Assets"

The message of the first two sections of this chapter is that the importance of the banking system to the economy must be matched by both ethical and efficient behavior by those in charge. In addition, in every jurisdiction the laws are for everybody. *If* banks are "too big to fail" and those in charge of financial powerhouses are "too big to jail," *then* ethics take leave and personal responsibility goes in exile.

When this happens roles are easily reversed. There is a joke in Italy that Michele Sindona, who managed the money of the Italian mafia, was a crook who became a banker. By contrast, Roberto Calvi, the president of Banca Antonveneta (a major Italian bank), was a banker who became a crook.[9] Ivar Kreuger was an engineer who became a banker and then turned into a crook. His wheeling and dealing was known, but nobody bothered to stop him since he had deep pockets (using other peoples' fortune) and in the interwar years (like today) sovereigns would sell their soul for cash.

Quite similarly the cases we studied in section 2 were of banks whose governors were uncertain as to which side of the entrepreneurial spectrum they belong: that of the manipulators, and therefore of "mismanagers" of other peoples' wealth, or that of honest business persons. Nothing has changed since that time. While the financial crisis that started in 2007 has produced the deepest recession since the 1930s, nearly all of the financiers at the heart of the storm opened their golden parachutes and landed safely. Nobody asked them about their accountability for the disasters, while:

- The biggest banks are becoming bigger than ever,
- Financial products that provided the debacle are back in favor, and
- Bonuses are flowing once again (chapter 1) to the pockets of those who don't deserve them.

The old saying about bankers that they believe in capitalism when it comes to pocketing the profits and in socialism when there is an overriding need to pay for the losses, proves once again to be true. It is not without reason that Dante consigned moneylenders to the seventh circle of hell, the one also populated by the inhabitants of Sodom and other practitioners of vice.

In economics and finance the conflict between theory and practice comes from the fact that without money to grease them, the wheels of fortune turn slowly or not at all. In an essay against the Rothschilds, Heinrich Heine, the German poet, fumed that money is more fluid than water and less steady than air. At the same time, however, it is no less true that money makes the world go round.

In the fifteenth century when the Medicis, Bardis, and other families ran the banking industry northern Italy's economy boomed. After the fall of the Florentine houses economic leadership passed to Venice and then to Holland with Amsterdam as the epicenter. From there, in the nineteenth century, economic might changed its domicile to London as England pulled ahead while other countries fell behind or dwelled in poverty. A century later New York rose to prominence on the strength of the American capital market, but for how long?

The rise of dynamic financial centers eventually tapers off and decades or centuries later it is followed by their fall. The main reason is not the drive of the challengers but mistakes that are (unavoidably) made in the course of years, particularly those that are being repeated. The rising stars of the Medicis and Bardis fell from heaven when they made big loans to the sovereigns of their time, and the king of England defaulted.

In the early twenty-first century big banks got deeply involved with subprimes and if only Lehman went bust it was because governments filled the empty coffers of big private banks with public money in an eleventh hour effort to refloat them. Taxpayers did not like that rotten policy of sovereigns, but nobody ever asked their opinion.

Worse yet, nothing seems to have been learned from the risk of slicing and dicing the subprimes and Alt-As[10] in 2005–2007, and from the economic and financial hecatomb that followed it. So in 2013 and 2014 the same silly business again came up in the foreground and left troubling questions in its wake.

Regulators are among the parties to blame for excesses by commercial and investment banks. On January 10, 2013, it was revealed that the Bank of Spain, the kingdom's reserve institution and regulator of the country's banking industry, ignored warnings from its inspectors about wrongdoing in the credit institutions it supervised. This was not the first time the Bank of Spain has been the target of fierce criticism. In 2012, when Madrid sought a Euroland bailout to rescue Bankia and several other Spanish lenders, it was revealed that regulators knew of Bankia's derelict state but looked the other way.

That's where demagogy comes into the picture. A report published in the *El Pais* daily has claimed that the Bank of Spain took no corrective action when its staff found indications of misdemeanors in the banks it were supervising.[11] This allowed Spain's regional savings banks to embark on a massive lending to property developers and home buyers. Spain's central bank is also accused of having insisted until late into the crisis that there was no need to shore up banks' capital.

All this adds up to the fact that the kingdom's reserve institution and bank supervision authority finds itself at the center of a debate of not doing its job in spite of warnings by its inspectors before and during the economic crisis. It's nice to say that the reforms being currently implemented will ensure that if a credit institution runs into serious difficulties its owners *and* creditors—not the taxpayers—must be the first to foot the bill. This is what definitely should be done, though it does not relieve the regulators from doing their duty.

Moreover the minimum requirements for (capital and hybrid) capital must be raised to ensure that banks are sufficiently resilient. In parallel to this the risks to financial stability that may arise from unsound public finances must fall on the heads of those who create them: the sovereigns. Hence the need for regulatory measures to reduce the concentration of risk exposures of governments on bank balance sheets by:

- Appropriate and realistic sovereign risk weighting, and
- Prevention of excessive credit concentration on government loans and government bonds.

In addition, if they are deemed systemically important, banks, insurance companies, and other financial institutions should face higher capital standards and increased regulation. Supervisory authorities should not be too secretive about how they make such decisions. A sound management principle is that higher capital requirements and tighter supervision should go hand in hand with the commercial and industrial banks' shift toward higher risk "assets."

This is not being done and here again demonology has a role to play in connection with risky "assets."[12] As 2013 came to an end, the US banks issued (not necessarily held) a record number of sliced and diced securities. This is a clear sign that financial institutions seek to boost profits by beefing up their risks. But what about the aftereffects on the economy?

The new wave of financial portfolios full of structured products is raising concerns that in an effort to make up for low interest rates banks could be assuming more exposure on their balance sheets than they can afford. In essence, this is a repetition of the precrisis environment in which banks created, traded, and inventoried high-risk securitized assets.

According to data released at end of November 2013 by the Federal Deposit Insurance Corporation (FDIC) the banks' holdings of structured products rose to almost $70 billion in the three months from July to September 2013. This is a cool 45 percent increase compared to the same period in 2012. It is also the highest level since the FDIC began breaking out individual figures in 2009.[13] The engineered, traded, and inventoried securitized products include:

- Collateralized loan obligations (CLOs),
- Collateralized debt obligations (CDOs), and
- Commercial mortgage-backed securities (CMBSs).

In 2013 purchases of such very risky assets not only by banks but also by institutional investors like pension funds, endowments, and insurance companies, as well as by firms seeking to refinance old loans surged to their highest levels since 2007,.[14] The irony is that one of the reasons given by banks for this rush to buy risky assets is higher legal expenses resulting from the Department of Justice penalties of having misled investors in connection with the:

- Subprimes, and
- Mortgage lending.

Regulators are also voicing concern that banks tend to increase the duration of their portfolios, which creates the risk of losses if benchmark interest rates move north. This is an added aspect of *interest rate risk* introduced into the financial system by central banks—an unwise move that has created a vicious cycle because, as banks and other players explain, nearly zero interest rates obliged them to deal in higher risk assets.

Recent major financial failures don't seem to have taught a lesson. Yet, the indiscriminate trading of garbage that led to the 2007 and 2008 economic and banking crises exposed the flaws of downplaying the impact of exposure.

Let's face it. Banks don't examine with the required depth and breadth the risks they are assuming with the resurgence of CLOs, CDOs, CMBSs, and other structured risky "assets." Evidence is provided by the taped conversations between three executives of Anglo Irish Bank leaked to the *Irish Independent*.

These in-house conversations offer a depressing insight into the thinking of Ireland's bankers during the crash. Indeed, Dublin feared that the broadcasting of these shocking conversations between executives at Anglo Irish, in which they laughed about abusing Ireland's bank guarantee to attract deposits, could hurt attempts to win debt relief, and for once politicians were right in their pessimism.

Neither were the executives of Ireland's failed banks the only ones who lived in a bubble world of hubris and easy money. Several bankers in the City of London and at Wall Street also showed little or no regard for the public purse, which eventually was used to rescue them. Ethically, it was a deadly wrong practice, and materially it was not profitable as many bank executives, regulators, and politicians who brought the Western economy to its knees enjoy gold-plated pensions no matter what they had done.

Investors, too, are to blame for the ruin of the economy. The historical fallacy is that "we are long-term investors so we can afford to take short-term risk in pursuit of higher returns." But a big bet on securitized products, even if they are sugar-coated as fake AAA bread and butter bonds or any one asset class, also entails a lot of long-term risk.

4. Wachovia Falls on Its Sword

A frequently recurring sticking point in the wave of mergers and acquisitions that followed the September 2008 bankruptcy of Lehman Brothers and the nationalization of AIG, Fannie Mae, and Freddie Mac, was the valuation of the fallen banks' assets. The misfortunes of big American banking corporations—because of the subprimes and other silly investments they went into in a big way—wiped out Wachovia. Formerly, this was a mid-Atlantic Coast superregional,

- Subsequently becoming the country's fourth biggest lender, and
- Then descending to the abyss.

Analysts watching Wachovia's rapid rise credited the ascent to sound management, but then it was revealed that it, too, was exposed the big way to the subprimes toxic waste. In late July 2008, after it was announced that Wachovia had made an $8.9 billion loss and taken $6.1 billion in writedowns the market became nervous about the bank's finances; its shares plummeted and it became another player in the fire sale of formerly sound financial institutions.

All that came as a shock because prior to its downfall Wachovia was one of the largest banks in the US, with operations in consumer/commercial banking, retail brokerage, asset management, and investment banking. Its business activities came under increasing pressure due to its exposures in mortgage and related securities and the future earnings risk Loss provisioning and asset markdowns exceeded estimates, though the company sought to maintain adequate capital ratios and liquidity.

Wachovia also suffered greatly from real estate exposures as well as from an ill-advised acquisition that swamped it with adjustable rate mortgages (ARMs) in California. By July 2008 its equity lost more than 75 percent of its value at the beginning of that year. In the same month Washington Mutual was confronted with a loss of $3.3 billion and net write-downs of $2.2 billion. America's biggest savings and loans outfit was seized by federal regulators and its banking operations sold to JPMorgan Chase.

At end of September 2008, the news was that Citi was buying Wachovia for about $2 billion while also absorbing $42 billion in liabilities (compensated by $12 billion from Washington). A few days later, however, the name of the white knight changed as Wells Fargo bid $15.1 billion for Wachovia versus $2 billion offered by Citi. Here is Wachovia's drama in slow motion.

The takeover by Wells Fargo was announced just four days after Citigroup thought it had won the battered bank, valued at about $11.38 billion. But Wells Fargo had an edge not only because it offered more money but also because it did not request the taxpayer's money. Unlike Citi's original agreement, the Wells Fargo takeover did not involve governmental financial assistance; analysts however said that other consequences of courtroom hostilities and dueling press releases could be messy.

Washington's officials were concerned that the way the competing deals unfolded might deter US banks from agreeing to government-assisted transactions. At the eye of the storm was Citi's legal claims for as much as $60 billion in damages from Wachovia and Wells Fargo. Shares of Citigroup fell when its bid was torpedoed, while its management stated its shareholders had been unjustly and illegally deprived of the opportunity the transaction created.

While Citigroup insisted publicly that it was still willing to buy most of Wachovia, people close to the company opined that additional due diligence uncovered questions that made executives uncomfortable about proceeding with the deal. Citi was itself badly wounded by the crisis, and even if its size made it the recipient of government loans nobody could say that it was out of the tunnel.

With government-guaranteed money Vikram Pandit, Citi's CEO, said in a statement that walking away from Wachovia could put Citi back in the market to buy another bank. On the other side of the negotiating table, a person close to Wachovia stated that Citigroup officials did not express serious concerns about the bank's books until talks reached an impasse. Another uncertainty involved how Wachovia, which had 3,348 retail branches, would be divided between Citi and Wells Fargo.

In Wachovia's hometown of Charlotte, North Carolina, the Wells Fargo offer was widely seen by the wounded bank's employees as more accommodating than that of rival Citigroup. The Federal Reserve concurred stating it would immediately begin consideration of acquisition filings by Wells Fargo, also noting "the considerable efforts" of Citi and Wells Fargo to reach an accord. Eventually, the die was cast in Wells Fargo's favor.

Critics commented that the wave of mergers, acquisitions, and government support spent to return the American banking industry to the health it enjoyed prior to the crisis that started in 2007 with the subprimes,[15] failed to reach its announced goals. The majority of economists were inclined toward this conclusion, with some negatively reacting to the measures taken in the US and Europe to get out of the spell of failures. Economists who depended on empirical evidence rather than dogmatic theories for solving the crisis were particularly critical.

These reactions have not been a passing blame. By July 2012, nearly four years after the printing presses of the central banks started to work overtime to solve the problems created by the crisis, governments had not understood the economic realities and that it was better to press on the decelerator of debt issuance than on the accelerator because the latter leads straight to bankruptcy.

Mario Draghi, the president of the European Central Bank (ECB), said in a lecture to the EU Parliament, in April 2012, that the European Union countries were probably in the most difficult phases of a process in which fiscal austerity was starting to reverberate its contradictory effects. Austerity had taken a larger-than-expected toll and demand was tumbling for loans to business and consumers despite ECB action to help the region's banks.

While Draghi appeared to echo demands from the EU member states for action to support growth, the ECB president saw any such plans as focused on growth-enhancing structural reforms and boosting "competitiveness," which had become elusive. Draghi stated: "If we say Germany will pay to cover the debts and deficits [of southern countries], I understand their reticence. Everybody must make their efforts on public finances. But Germany must realize that it is growth that will allow us to solve a big part of our problems."[16]

Sovereigns found themselves in the same blind alley of growing indebtedness that big banks had encountered before them in the aftermath of the crisis. Even a US bankruptcy was no more off the table. Interviewed on July 2, 2012, by *Bloomberg News*, the chairman of Honeywell had an advice for the US government. The monitor asked: "As a successful businessman, given Honeywell's results, what would you have *done* to redress the American economy if you were running the government?" Without any hesitation, Honeywell's chairman answered: "I will declare bankruptcy."

It was implicit in this exchange that there was no question things would return "as usual" with budget deficits a daily ritual and ever increasing endowments becoming common currency (section 4). While taxes will rise, in order to make ends meet both the quantity and the quality of public services will have to shrink. In a way not dissimilar to the experience of clients of budget air carriers, citizens will be confronted with a low-cost ride; they will need to provide by themselves for their education, pension, and health care.

If this seems “unthinkable” (chapter 5), think again. From 2008 to 2010, at the peak of the banking crisis, many unthinkable things have turned into reality. This is why Wachovia is an interesting case study, and it is not alone. With the exception of Lehman, which went bust, the carcasses of all other major banks that went into oblivion found shelter under some surviving institutions—thanks to the government.

This could not last forever. By 2014 the government became the predator. Standard Chartered paid dearly for its Iranian deal—$327 million (chapter 8) —while ING coughed up $619 million. This was the hors d’oeuvre. The penalty applied to UBS by the US government was much higher and the most likely intention was to throw it out of the New York capital market. Then came other cases. Credit Suisse pleaded guilty in the US, and cashed out $2.5 billion—in a reverse play of the fate of Wachovia and other big banks, but indeed “unthinkable” till it took place.

As of June 2014, the latest news is the prosecution of BNP Paribas, the largest of the three big French banks. BNP has been asked to pay $10 billion for the privilege of being present in the New York capital market (theoretically for violating US rules for trade with Iran, Sudan, Cuba, and the like). Criminal prosecutors are all over the place, and, as is to be expected, French politicians and public opinion are outraged. The bank’s chairman Baudouin Prot took a couple of months off due to burnout caused by the stress of the bank’s inquiry into alleged wrongdoing.

The transatlantic tussle over the foreign banks’ settlements escalated further when Barack Obama said he would not intervene in the matter. In his words: “The president does not meddle in prosecutions. These are decisions made by an independent Department of Justice.”[17] His comments came as France’s market watchdogs warned that uncertainty over the size of the fine was causing confusion in the financial market. It needs no explaining that it is not good to have such an amount of penalty hanging in the air—but is this not another unthinkable happening that could turn BNP Paribas into “Wachovia Bis”?

5. Investor Activism and Creative Accounting

Financial history books suggest that the market for securities trading developed in London in late seventeenth century (though the first company known to having issued stock was Dutch). The concept underpinning securities trading, however, is much older because securities were similar to other forms of assets that predated them in trading and, over the centuries, ranged from food and artwork to land.

One thing that is new with securities, which are virtual instruments, is the new status given to speculation. Prior to the development of securities markets, speculation in money as well as in real estate had long been frowned upon. A lot of speculative activity was either illegal or the penalties for it were severe. In the beginning that applied to securities too, as early securities markets were tightly regulated—at least much better than they are today.

Nevertheless human nature being what it is, many people were quite willing to trade with speculators, which gave the latter some respectability even if, at least in America, the suspicion between Wall Street and Main Street has been and still remains strong. Scams have led to vigorous shareholder activism particularly during the year's round of annual general meetings. Big institutional investors, as well as smaller investors who acted in unison, voted against management's wishes particularly in regard to pay packages for executives.

Financial companies that confronted investors' anger include Barclays, Credit Suisse, and NYSE/Euronext. In large measure these were nonbinding revolts that caught companies off guard and some succeeded in their aim. Aviva, a British insurer, bowed to pressure and withdrew the pay rise for its chief executive.

The so-called bond vigilantes have been less successful than they would have liked to be remembered. Their fear has been that central bankers will be less focused on meeting inflation targets in future and more interested in the problems of unemployment and social unrest that might erupt. This gave rise to the world of "creative central banking" (alter ego to creative accounting) where reserve institutions keep the rate of interest they charge below the rate of inflation.

At other times, any central banker who ever admitted he was allowing a bit more inflation in order to stimulate growth and get unemployment down would be hounded out of his job. He would also cause a catastrophe in bond markets, say the bond vigilantes. In our times practically all Western central banks have done so, and in 2013 they were joined by the Bank of Japan.

Inflation-linked bonds are cheap insurance, say the critics of the wrong-way zero interest rate monetary policy, particularly when central bankers are effectively transferring wealth from savers to debtors and profligate governments. For people able to understand what is taking place, the fact that investors have been locking in returns less than retail price inflation has been difficult to digest.

Critics add that in their current monetary policies and practices central bankers have gone well beyond their remit. This is an interesting debating point. In essence Western governments found a way of paying interest to themselves on assets bought with interest-free printed money. Ivar Kreuger, Carlo Ponzi, and plenty of other swindling geniuses would have been very fond of this course of events.

Among the risks confronted by bond investors has also been a liquidity trap as regulatory changes designed to make the banking system safer have probably made markets more volatile. As a result, when it is time to correct current imbalances, it may be faster and deeper than many investors (and central bankers) have been anticipating.

In the background of this problem can be found capital requirements, liquidity requirement, trading desks, and the bankers' policy of gaming the regulations. Basel III rules require banks to hold larger amounts of capital against the bonds held on their trading books, while at the same time bank-funding costs have risen. The aftereffect has been that dealers have cut back on inventory.

- *If* banks are no longer willing to buy bonds,
- *Then* who will take the strain if retail investors stage a mass exodus from bond funds?

As bond funds dump their holdings, dealers are likely to lower their prices to the level at which they think they can find new buyers. It is difficult to say how the correction will play out because past experience is limited (save 1994 when the bottom dropped out of the bond market). Much will depend on what triggers it. The sell-off may be more gradual as investors simply reset their return expectations; or it may be ugly if investors lose confidence in the central bank and government policies (which is likely).

Dealing with the political establishment, its connections, and its whims is tough, but where investor activism is really powerless is with ordinary crooks. In early September 2000 the attorney general in Monte Carlo started an investigation for fraud after a number of complaints were registered by investors who said they were swindled by Hobbs, Melville & Co International N.V. The investors' complaints were:

- Deceit,
- Abuse of confidence,
- Use of fake documents, and
- Infraction of the law of principality.

All these "creative acts" of wheeling and dealing were debited to William Hobbs Fogwell and his daughter Shelly. Neither of them was anywhere to be found. Not only the Monte Carlo authorities but also the attorney generals of New York, Geneva, and Amsterdam —where the virtual investment company operated—were also actively looking for the pair but could not locate them.

The hook for investors was a return on investment of 30 percent to 40 percent per year, which was declared as being managed by Prudential Bache in London and Rand Financial in Chicago. It was all a Ponzi game, using the money of new clients to pay a high interest to those already in the books as well as to sustain the high life style of the virtual company's president.

In finance deceit is done through *creative accounting,* which leaves nearly everyone confused while the winner takes all. "The treaties must be as brief as possible, and in a couple of articles grant us everything," said Leopold II, king of the Belgians and master of deceit.[18] "Did you know, Dr. Cuccia, that Gemina (a large Italian holding) held double books?" asked the judge in a court case in Milan. "My son," answered the 90-year-old Enrico Cuccia, honorary president of Mediobanca (a large Italian investment bank), "in my long career I have known no company which did not have double books."

Neither the law nor shareholder activism has been successful in stamping out *creative accounting* practices, which lead to misrepresentation of financial data for the benefit of speculators or misbehaving enterprise management. Typically, the biased and twisted representation of facts has been carefully engineered (though on rare occasions it may as well be due to a major accounting error).

For instance, in November 2011, Germany's finance ministry said that it had discovered an embarrassing accounting error at a nationalized "bad bank." The country's debt had been overstated by €55.5 billion ($75 billion), affecting Germany's overall indebtedness, which dropped from 84 percent to 81 percent of GDP. That was a "good failure."

At about the same time, Ireland's finance ministry also uncovered a happy blunder centered around a €3.6 billion ($4.9 billion) accounting mistake at its housing agency.[19] That meant that the country's debt load was two percentage points lower than had been thought. Such examples, however, do not show up frequently whereas crooked creative accounting records are everyday business.

Creative accounting practices, for example, have been widely used by American banks, and most particularly by mortgage houses, specializing in fake profits and big bonuses. Securitized junk, conveniently rated as AAA, was employed to deceive the banks' customers—including other banks. The faking of the national accounts of Italy and Greece by using derivatives to hide budgetary deficits and join the euro is still another example.

Creative accounting is pervasive. In December 1996, the Italian government itself used a currency swap against an existing $1.6 billion bond (in yen) to lock in profits from the depreciation of the yen. In reality, this was a loan masquerading as a swap where Italy accepted an unfavorable exchange rate and received cash, which it employed to reduce its deficit and meet budget targets of less than 3 percent of GDP— another creative accounting practice aimed at gaming Euroland's rules.

The interesting thing about all this is that, while such cases are pure fraud, nobody has been brought to justice. Yet, there exists no difficulty in identifying prime ministers, ministers of finance, company presidents, treasurers, and investment bankers who engage wholeheartedly in such scams. The wrongdoers have not been pulled up except for some mild verbal condemnation, and even this was an exception.

Unpunished creative accounting leaves the door open to other even greater deceptions at all levels of government and banking. In Milan and other Italian cities, investment banks convinced administrators to use derivatives for window dressing to meet their city's obligations. As prices toppled, cities that gambled with derivatives and with creative accounting practices found themselves deeply in the red.

In the case of financial losses incurred by Italian municipalities, prosecutors brought to justice a swarm of well-known banks and bankers implicated in the scams. But in the much greater creative accounting scandals of the government itself and its Treasury there has been no corrective action and no prosecution; therefore, no house cleaning. No matter what it did, Rome did not have to confront legal trouble.

Moreover, we don't even know how many Euroland governments have used creative accounting. What we do know is that many countries entered Euroland's monetary union with bigger deficits than those permitted under the treaty that created the euro. What these governments should have done to balance their budgets was to raise taxes and reduce spending. Instead, some of them colluded with international investment bankers to reduce their deficits artificially by means of derivative financial instruments, paying no attention to the fact that their creditworthiness would become a joke and the course they chose would be unsustainable in the longer run.

6. From Model Risk to Insider Trading

Section 4 brought to the reader's attention that in the world of complex financial deals the prevailing accounting methods, as well as standards, are still unsure of how to put a value on the instruments that get a company into trouble. In old times, the principle with financial statements was to record the value of an asset at its historic cost: the price the company paid for it. But under fair-value accounting it had to be recorded at its market price: the price at which it could be sold. The problem is that many derivatives, for instance, mortgage-backed securities (MBSs), do not trade smoothly, making it impossible to mark them to market. They have a real price only twice in their lifecycle: when they are designed and when they are finally sold. Hence, companies resort to "marking to model" or "to myth."

Because of failure of mission, or of commission, the price computed by the model does not always resemble the market. When this happens, the company marking to myth runs into trouble. In addition, bankers worry that if their instruments are sold in a falling market, the low price would damage their portfolios:

- Forcing them to slash carrying values on their books, and
- Driving prices further down in a vicious cycle.

That's bad in itself, and experience teaches that the market does not need to be illiquid to reach such a result. "Smart" bankers have also found that the model can be manipulated and used to produce "losses," creating a sizable difference between marking to model valuations and true market prices. (The accounting standard has changed and it allows the recording of a portfolio position at acquisition price *if* management's intent is to hold it in the longer run. A portfolio position, however, is not cast in stone.)

This does not mean that models are useless. In principle though all models are wrong, some are useful. Beyond "right" or "wrong" lies the fact that models easy to manipulate can be the source of major problems. All sorts of surprises can come out of them, even when they are used to smoothen the results of too much volatility in the books.

The criticism is not limited to eigenmodels, that is, those designed by banks. It extends to "official" models like *value at risk* (VAR), which has become obsolete and unable to tell anything precise about exposure. Back in the mid-1990s the Basel Committee introduced the use of VAR as a tool to effectively control risk. Senior management was asked to be actively involved in risk control and review the reports produced by an independent risk management unit.

In other terms, risk control models must be closely integrated with the day-to-day running of the financial institution. The results of experimentation on exposure should both be reviewed by senior management and be reflected in policies while the board of directors sets the limits to exposure.

This is more effectively done when the model provides an objective quantitative explanation of the factors behind a rising VAR, but this aim is not fulfilled by the current status of VAR. Besides there exist not one but many versions of VAR, each claiming to be better than its competitors.

Indeed, one of the problems with models is that they tend to be heterogeneous, making the job of supervisors and regulators—as well as the company's own management —so much more difficult. To reduce differences between models, the Basel Committee has fixed a number of parameters that impact the way VAR versions are specified and developed. For example:

- A 99-percent one-tailed distribution defining the level of confidence (not observed by banks, as some use 95 percent and others 97.5 percent).
- A minimum period of statistical sampling of one year is employed in terms of historical information.
- Price changes over a two-week period are used to check fluctuations in price volatility.

In daily practice there exist complex requirements like accounting for nonlinear behavior of option prices. Accounting for them makes the model more sophisticated but not standard; not accounting for them results in VAR answers being questionable. Another issue leading to diversity in output are the historical correlations used in value at risk models.

The Basel Committee permits banks to employ the correlations that they deem appropriate within and between markets, provided that their supervisory authority is satisfied with this process. Not all supervisors, however, have the skills and experience necessary to present a firm opinion on that and related issues.

Quite often value at risk and other models are mishandled because what they can and cannot do is misunderstood much. VAR has very frequently been subjected to wrong assumptions regarding the area of its implementation, and therefore to improper usage, being the outgrowth of a simple model developed by the Morgan Bank to inform its senior management about current exposure. It is only reasonable that a relatively simple model does not answer the requirements of sophisticated banking products in terms of embedded risk.

- The simple, parametric VAR aggregates recognized losses under conditions characterized by a normal distribution of events.

- Basically VAR neither addresses extreme events or circumstances, nor does it take account of leptokyrtotic distributions with asymmetric tails.

One of the difficulties in proper implementation of value at risk metrics is the misunderstanding of its limitations on the part of its implementers, given the prerequisites to be fulfilled. To be used as a measure of exposure, the model must be fed with:

- Market prices,
- Volatilities, and
- Correlations.

If they wish to get meaningful results through VAR, the implementers must satisfy themselves that the above three factors are well measured, databased, and tracked to ensure they are stable. In fact, as a requirement this is in itself a contradiction because volatility is not stable, correlations are not well established, and over the counter (OTC) market prices are usually not available.

Further on this issue, the manipulation of financial results through models has joined that other flaw of business, insider trading, as a reason for intervention by supervisory authorities. Insider trading has been used for decades without interference by law, particularly in England. The big change came in the early 1960s when the prosecution of insider trading started in America. One of the big fish to be caught in the net of justice was SAC, the hedge fund. It has been selected as a case study to explain:

- The problems encountered by the authorities, and
- The long time it takes for justice to be done.

SAC Capital is a $14 billion hedge fund. In early 2013 the company agreed to pay a record $616 million settlement of civil insider trading accusations with regulators. In New York it is said that right after the settlement Steven Cohen, its founder and CEO, spent $155 million on *Le Rève*, a Picasso painting. Little did he know that this was the beginning, not the end, of his troubles.

Wall Street saw Cohen's investment in art as defiance of the fact that SAC had been charged by US civil and criminal authorities on four counts of securities fraud and one of wire fraud. It was accused by the government of insider trading that was substantial, pervasive, and on a scale without known precedent in the hedge fund industry.

The case of the government versus SAC capital involved attorneys from the Securities and Exchange Commission (SEC), the New York bureau of the FBI, and the US attorney's office in the Southern District of New York. It started several years prior to the $616 million settlement and took time to gain momentum. While the questions about Cohen's role intensified, the authorities did not believe they had enough evidence to support criminal or civil insider trading charges. Cohen denied any wrongdoing and so did SAC.

But the investigation continued and by 2009 the federals had obtained enough information to step up their questioning. A routine investigation into the trading of supermarket chain Albertsons' stock led the authorities to a former analyst at SAC. His answers to the questioning about the trading helped the FBI get a breakthrough. The same contact also provided leads on suspicious trading in some stocks such as Elan, a drug company, as a part of the government's case against SAC.

Another company that attracted the authorities' attention for investigating suspicious trading was the Galleon Group, an $8 billion hedge fund run by Raj Rajaratnam. This was an example of a lead that created a bridge to other leads, eventually taking the investigations into Cohen's inner circle at SAC. While listening to a wiretap from late summer 2009, US authorities picked up conversation.

When in the first days of January 2014 prosecutors opened their trial against Mathew Martoma, a former SAC Capital portfolio manager accused of insider trading, practically everyone knew that the real target was Steven Cohen. The founder of SAC had not been accused of insider trading, but following a phone conversation Martoma and Cohen had in July 2008, the hedge fund sold $700 million of two drug company stocks

The bets that the shares of Elan and Wyeth would drop allegedly constituted the largest single insider trading offence in US history, making $276 million in profits for SAC, while losses were avoided. Still, despite months of pressure from authorities and the possibility of a decade in prison if convicted, Martoma maintained his innocence and refused to cooperate in the probe into Cohen's trading—but the record settlement between SAC Capital, the hedge fund, and the SEC was a clear example of the US watchdog's tough approach.

Hedge funds are now paying much closer attention to what they put in emails and text messages. They avoid anything in writing that could incriminate them in the event of a regulatory investigation. The "heads I win, tails you lose" principle of dealing no longer attracts headlines. Companies no longer advertise that they have a long list of new ventures that succeeded and a short list of those that failed.

The end of SAC's guilty plea has provided plenty of food for thought. Through its general counsel the hedge fund pleaded guilty to insider trading in November 2013; the judge did not finalize the pact until a couple of months later when she accepted the guilty plea by SAC Capital and ordered a $1.8 billion fine for insider trading. This was the end of a long-running investigation that forced the hedge fund to close itself to outside investment.

Essentially the judge ordered a $900 million fine, plus $900 million in the forfeiture of illegal profits from the trading scheme, which lasted nearly a dozen years, from 1999 until 2010. About $616 million of the forfeiture will be recovered from a previous civil settlement with the SEC. For Steven Cohen, the legal trouble has not ended. If found liable for SEC's allegations that he failed to supervise employees who engaged in insider trading, he faces a potential bar from the securities industry and who knows what another judge may say regarding his role with SAC Capital.

7

Libor Scandal, Derivatives, Gold Deceits, and the ETFs

1. The London Interbank Offered Rate

Libor stands for the London Interbank Offered Rate, which has been, for years, a generally accepted interest rate benchmark. Unveiled in 2012, the scandal associated with it caused turmoil in the financial industry and it was censured by the Bank of England, the New York Federal Reserve, and other central banks. What started as a misdemeanor with Barclays developed into a wide conspiracy with commercial and investment banks forced into costly settlements.

- Barclays, the first big bank whose name was associated with the Libor scandal, has been condemned to pay $450 million,[1] and
- While its top management (CEO and chairman) was swept away, the British bank faced criminal indictments if any evidence of collusion was found in American markets.

Theoretically the Libor system worked like a clock. Practically it was open to abuse. Every weekday, at about 11:30 a.m. British time, trading screens are updated with the day's new interbank offered rates. These numbers are provided by major institutions and they are supposed to measure the interest rates banks would pay when they borrowed from each other.

This procedure was developed in the 1980s to simplify the pricing of interest rate derivatives and syndicated loans, which blend funds provided by different banks. The British Bankers Association (BBA) started publishing Libor rates in 1986 and they quickly became a basic reference and yardstick for the cost of liquid assets. Note that Libor has not been the only global financial benchmark. Other examples are:

- Central bank rates, and
- Government bond yields.

But Libor is special because contracts worth some $350 trillion, or 500 percent the global GDP, are based on them—affecting markets around the world. In contrast to other benchmarks, however, Libor is not based on real borrowing costs. This might well have been its Achilles' heel, as each bank "estimates" the rate it would be charged *if* it borrowed cash that day, doing so in a matrix of 15 maturities in ten different currencies. How realistic and objective could *that* be is open to question.

The manipulation and misreporting of interbank interest rates was no one-tantum event. It went on for some years, almost openly. About a thousand days prior to the Libor scandal becoming public knowledge faculty members at New York University had found out what was going on and suggested a simple and effective way of dealing with it.[2] But, as it is so often the case, no action was taken by the authorities.

In addition, a 2008 study by the Bank for International Settlements (BIS) spotted days when financial risks spiked but Libor did not. This was not normal because typically lending rates are greatly influenced by credit risk, and a disconnect might well suggest collusive conduct between banks, including price fixing.

In short, both regulators and competition authorities failed to follow up on the early signals of a major financial scam; this proved to be a serious mistake as the supervisors' inaction was interpreted by the bankers as benediction and the discredit went on. All but forgotten was the fact that a credit institution must never depart from complete honesty and correct behavior. Scandals further undercut popular confidence in finance; they also reduce liquidity and credibility when they are badly needed.

The pros say that if there was any bias averaging out would have taken care of it. This is only half true. It could be the case if the measurements or estimates are independent; this did not happen with Libor. Instead they were biased and they were massaged. That's precisely where the scandal lies.

In addition, Libor was subjective by design. Up to 20 big banks submit their best guesstimates of lending costs. Once these were all in, Thomson Reuters ranked them on behalf of the British Bankers Association.

- First it removed the top and bottom quartiles,
- Then it averaged the central 50 percent of guesstimates and published the day's Libor fixing.

Such a procedure does not remove the influence of manipulations. The distribution of interest rates was a bankers' poll, not a statistical measure, and the way it turned out banks had an incentive to massage the numbers because their actual borrowing costs were influenced by their guesswork. It's matter of promoting profits and, therefore, bonuses.

Critics also pointed out that Libor was a case of cooking the books waiting to happen. As in many areas of the bond markets, derivatives, and commodities, indices are often drawn up on the basis of prices guesstimated by banks and their dealers. According to an African proverb, a man doesn't go among thorns unless a snake is after him, or he is after a snake. The snakes in this case wereprofits and bonuses.

The same snake-induced operational risk prevails in the oil market price-setting, carried out by news organizations and open to manipulation by the submission of false prices. IOSCO, an international regulatory group, has warned of this risk. By contrast, the risk is lower with equity derivatives that are priced with reference to how shares trade on public stock markets.

Reflecting on these facts, on June 29, 2012, Mervyn King, the then governor of the Bank of England, said: "Libor manipulations have shown how the banking culture has gone wrong."[3] Four days later in his deposition to the British inquiry committee Bob Diamond,[4] president and CEO of Barclays, confirmed that his institution and its competitors had manipulated Libor. He also accused the regulators for not being watchful enough, but failed to admit that when ethics are ostracized:

- The bankers can do as they please in gambling with other peoples' money and in engaging in scams and scandals, and
- *If* the regulators cannot catch them because the politicians tell them to turn a blind eye, *then* the whole financial system is at fault.

In London, for years, Diamond was seen as a success story of investment banking. After he packed up his desk, politicians turned thumb down. David Cameron, the prime minister, spoke of "appalling and outrageous" behavior. George Osborne, the chancellor of the exchequer, said Diamond's departure was good for Barclays and good for the country. Britain could now rediscover "a culture of responsibility"[5]—a sense that, in banking circles, has been long overdue.

Indeed, part of the controversy surrounding Barclays in connection with the Libor scandal revolved around Diamond himself and the sheer nakedness of trader greed. At an annual shareholder meeting prior to the scandal's breakout a third of those present voted against the pay report of the previous year after it emerged that the bank's CEO had received

£25 million ($40 million) total remuneration, including a controversial tax equalization payment.

The culture of Barclays was coming from the top, said a British regulator,[6] suggesting that he and his colleagues had harbored qualms about the big bank for a while. According to critics Barclays gave the confusing and potentially misleading impression of its capital strength when regulators carried out stress tests of big European banks.

In conclusion, the Libor scandal added a new dimension to the reputational disaster of credit institutions following the 2007 hecatomb with the subprimes and the 2008 big bank failures. Experts said that it was unlikely this is the only trading domain where such malpractice is rife.

Lord Turner, then chairman of the Financial Services Authority (FSA) stated that "we would be fooling ourselves" to assume the alleged malpractice in Libor were not current in other types of trading. There is a degree of cynicism and greed which is really quite shocking…and that does suggest that there are some very wide cultural issues that need to be strongly addressed."[7]

2. Were Regulators Part of the Deception?

Belatedly, after the scam, more than a dozen enforcement agencies in the United States, Canada, Britain, Continental Europe, and Japan have been examining whether bankers and brokers colluded to manipulate Libor. Included in the investigation by some regulatory authorities were, as well, other widely watched rates for possible scandals aimed to bolster profits from in-house trading positions. Analysts suggested that the Libor fraud had two reasons, each connected to one kind of unethical behavior.

- One was designed to manipulate the benchmark to bolster traders' profits.
- Allegedly Barclays' and other banks' traders pushed their own money-market desks to manage submissions for Libor and for Euribor, the euro-based interest rate put together in Brussels.[8] They were also colluding with counterparties at other banks, making and receiving requests to pass on to their colleagues.
- The other type of Libor rigging started in 2007 with the onset of the credit crunch, as something supposedly done "for the public good" (let me laugh).

The argument goes like this: A high Libor submission has been seen as a sign of financial weakness. Hence banks lowered their submissions and (if you can believe it) in this way they became benefactors of humanity.

More disturbing is the news that they got a green light from the Bank of England (and Whitehall) as well as from the New York Fed to do what they did. In America, it emerged that the Federal Reserve Bank of New York may have been informed of alleged manipulation of Libor some time after 2007.

The Bank of England denied such allegations, but the suspicion remained that at least some banks were submitting low Libor estimates with tacit permission from the regulators. During this time the president of New York Fed was Timothy Geithner, who subsequently became Barack Obama's Treasury secretary, and he believed that whatever he did was the right thing. How could it be otherwise?

There have been attempts to improve Libor and other rates, but they created fresh problems. For instance, using a larger sample of banks and forcing them to report actual transactions, rather than guesses and intentions, might improve the calculation of the interest rate benchmark. But:

- A big sample would be more difficult to manage and not necessarily unbiased, and
- In a dynamic market like that of interest rates, prices might change many times, moving away from the information on already executed transactions.

A more effective way of dealing with the problem of bias is to establish rigorous procedures by legislation, with criminalization in case of a violation. A different way of making this statement is that while in isolation each of changes under consideration might be sensible, in the aggregate they may well pose a different set of challenges. For instance:

- To minimize the risk of being prosecuted banks may simply stop contributing Libor estimates.
- If civil lawsuits against banks are big, they could undermine financial stability, and
- Much bigger panel samples would probably include banks that are smaller and less creditworthy than the present set of banks submitting rates, leading to more unstable Libor rates.

There is also the likelihood that once the heat of the Libor scandal has abated, some of the regulators will return to the blind eye policy, which will give banks a go-ahead for the next scandal. There is no better solution than to enhance personal responsibility with heavy penalties for managers (not for the banks, hence the shareholders) including prison terms.

If this is done, *then* the Libor scam will be delivering an interesting case on the many facets of business ethics. Much would be expected from the criminal investigation leading to court proceedings so that those who engineered the scam spend time in prison. Today it is "heads I win, tails you lose." By contrast, the carrot and stick provides good guidance of the right way, while the carrot alone ends in downgrading ethics.

The carrot and stick is also the better means to ensure that ethics as well as efficient commitments are made and respected. In his July 18, 2012, interview by CNN, Carl Levin, of the US Senate Banking Committee, stated that regulators failed in their job. But then he underlined that banks must fulfill their commitments to change the culture. Levin saw this as an urgent matter that has to spread through the global banking industry for it to be ineffective.

Along with pinpointing personal responsibilities for Libor and other scandals, it would be wise to examine documents and reach conclusions on the impact they have on loans. There are at least 900,000 outstanding US home loans indexed to Libor that originated between 2005 and 2009, the timeframe over which the lending gauge seems to have been most rigged. According to the US Office of the Comptroller of the Currency, these mortgages carry an unpaid principal balance of $275 billion.

Households with loans tied to Libor, because they were silly enough to get mortgages in foreign currencies, have probably paid higher rates. Some financial analysts also speculate about what is referred to as the *lying premium* theory regarding Libor submissions.

In the opinion of these analysts banks could have an incentive to lie if a large number of derivatives used a particular Libor rate as reference. In a July 14, 2008, email, one Fed official noted that the principal concern at the International Monetary Fund (IMF) centered on who provided the Libor quotes in the banks,[9] examining if the rates came from funding desks as opposed to derivatives traders.

New York–based International Swaps and Derivatives Association (ISDA) said actual transactions are few and far between for longer-dated rates, including the six-month rates that are the basis for up to 40 percent of Libor-based contracts.[10] Nobody, however, denied the legal risk associated with the Libor scandal, whose impact and cost became better known as 2012 came to a close.

Evidence has been provided by the fact that big banks allegedly involved in rigging the benchmark interest rate, did not react loudly when they got hefty fines. A big one was levied on December 9, 2012, when American, British, and Swiss authorities imposed penalties of Swiss francs 1.4 billion ($1.55 billion) on UBS.

In its legal settlement with regulators the Swiss bank admitted to widespread and routine attempts to manipulate Libor rates. (Its fine came six months after the earlier settlement and admission by Barclays.) This has been an escalation of the risk faced by large and complex banking groups, because of:

- The size of the fine, which was three times larger than that paid by Barclays, and
- The fact that Moody's, the ratings agency, noted the fine was *credit negative* not only for UBS but also for all banks with sizable capital markets activities.

With fines having reached unprecedented heights legal risk has added its weight to the big banks' other woes. Investigators allegedly found more than 2,000 documented attempts to manipulate rates, and the case of other big banks involved in the scandal was no better. Regulators in America, Britain, and Switzerland let it be known that they were ready to impose far bigger penalties than they used to.

The Royal Bank of Scotland, which hoped to reach a downsized penalty because of its frail financial condition, got ready to pay a fine of at least $500 million. Suddenly it became evident that disclosures in the first legal cases pointed to wider efforts to manipulate interest rates than originally thought, including allegations of banks making improper payments to certain interdealer brokers.

Another measure of the developing litigation risk now facing big banks is found in the quarterly report of JPMorgan Chase. It suggests that the range of likely losses could run high. Legal expenses were anything but modest, reaching billions, while most other large international credit institutions faced similar investigations and lawsuits.

In conclusion, the manipulation of Libor rates by Barclays, Royal Bank of Scotland, and other big banks can be traced back to the lax system of regulation prevailing prior to the major economic and financial crisis that began in 2007 and is continuing. Looking the other way is a very weak regulatory response making it inevitable that disaster will strike.

Directly or indirectly, global banks that paid penalties admitted that they had submitted false Libor rates. Just as wrong was the response by the then president of the New York Federal Reserve, Timothy Geithner, who buried the case thereby establishing the wrong way of regulatory dealing, known as the "Geithner doctrine."

3. In Search of Ethics and Efficiency

History teaches that when plenty of money is involved in a certain process or project, the ethical rules are bending. This is bad for ethics and also counterproductive as far as efficiency is concerned. The absence of meaningful negative consequences encourages fraudulent conduct and ensures that incentives go the wrong way. The absence of personal responsibility and accountability further reinforces the wrong incentives, eventually ending in disaster.

As section 2 brought to the reader's attention plenty of big banks have been involved in the Libor scandal and paid high penalties for it, because senior management, traders, and everyone else who contributed in setting the rates often had every incentive to be manipulative. Lack of transparency exacerbated the tendency to lie.

The surprise has been how many senior bankers found no difficulty in collaborating in the Libor scam. The investigation revealed that JPMorgan Chase had coordinated its Swiss franc Libor submissions with the Royal Bank of Scotland. That was confirmed by documents filed in connection with the latter's £390 million ($628 million) regulatory settlement with British and US authorities.

It is also interesting that the link established by big and complex financial institutions for rate fixing unveiled another side of vulnerability. Banks have been implicated in the Libor scandal through communications between traders. Other findings from the Libor-rigging saga revealed a clubby world where fortunes were made on:

- Friendships, and
- Connections.[11]

In his deposition to the British Parliamentary Commission on Banking Standards, which prepared a report on banks' governance and ethics, Marcel Rohner, former chief executive of UBS, admitted poor governance, badly designed pay structures, and acquisitive growth. In his words, they were all to blame in the Libor scandal.

Rohner also advocated changing bank remuneration models to give far more weight to group performance adding that such a structure "is more easily controllable through peer pressure . . . because the result depends on the group effort."[12] Other bank executives argued that the ability of senior management to spot problems would be helped by a simpler, smaller business model as well as by an effort to create a uniform set of standards, rather than having management overseeing a complex business that does not really understand.

Not to be left behind, the European Commission extended its antitrust investigation, which included yen- and euro-denominated swaps to encompass Swiss franc-linked instruments. The EU can impose a maximum penalty equivalent to 10 percent of a bank's global turnover for each cartel it finds involved in a given scheme. The commission has reacted to the Libor and Euribor scandals by proposing a draft legislation aiming to restore the integrity of these benchmarks.[13]

Other regulatory agencies, too, have joined the criticism of current rate-setting procedures. The International Organization of Securities Commissions (IOSCO) published a draft of new global guidelines for benchmarks including:

- Standards for governance,
- Regulatory oversight, and
- Conflicts of interest.

As these references document, the Libor fixing scandal led to an avalanche of criticisms. Regulators have been sparked by the fact that interest rates are not a parochial index. They are affecting markets around the world in a big way.

Neither could the offences for which big banks have been fined be linked to a political party of the right or left. In America they took place under both George W. Bush and Barack Obama's watch. In Britain they took place under the premiership of Gordon Brown, the former chancellor of the exchequer and mentor to both Ed Miliband, the present Labour leader, and Ed Balls, the shadow chancellor who was Brown's closest ally.

Interest rate risk and credit spread risk are the most important market exposures for the banking industry, and this has been a nearly pure bankers scam, like the subprimes. As the careful reader will remember from this chapter's previous sections, it also emerged from ongoing investigations that the bankers were only sometimes fixing the rate for personal gain. Other interests, too, played a role. In late 2008, they were putting in low submissions in order that the bank:

- Should appear healthy, and
- Is able to recapitalize itself.[14]

The nature and extent of the Libor scandal has demonstrated two more issues: The first is that not only scandals but also changes in the regulatory environment and intense competition could lead institutions toward wrong decisions that bias their business model. This applies not only to big banks but also to smaller commercial banks, savings banks, and credit cooperatives. They all need to steadily and carefully watch:

- Their ethical standards,
- Their profitability, and
- The economy's financial stability.

The second key issue is that half-measures are worse than nothing. The West needs a cultural as well as a policy revolution in banking, and here is where politics come in. Both right and left wing parties should show that they have understood what is at stake and vote for a thorough restructuring of the banking system. To make cultural and financial stability changes:

- They have to go well beyond ring-fencing advocated by the Vickers Commission and adopted by the British government, and
- Institute a Glass-Steagall–type separation of retail and investment banking assisted by the Volcker Rule, which essentially reestablishes the banking industry in its classical role of an intermediary.

As far as the watch over benchmarks are concerned, a good example is provided by Singapore's central bank, which, in July 2012, ordered banks in the city state to review how they set local interbank interest rates. For its part, the Monetary Authority of Singapore has been looking into how the local benchmark, the Singapore Interbank Offered Rate (Sibor), is set and whether this is in line with probes in America and in Europe.

In addition, any investigation worth its salt must go beyond Libor to include other benchmarks. Once it has been established that rate-fixing scandals find their way around the globe, every bank is suspect. Barclays had the bad luck to be the first to come under the spotlight, but it should not be forgotten that ongoing probes cover many of the biggest names in finance.

Without any doubt investigating authorities in every jurisdiction should provide maximum assistance to the authorities in other countries. For instance, the British to the Americans prosecuting British residents under Sherman Act criminal charges with respect to the Libor scandal. This must go all the way from evidence gathering to the extradition of suspects.

Criminal price-fixing is likely to catch a wide range of culpable traders and executives, as only evidence of collusion is required to establish the offense. "Modern banks are worse than the rail and oil conglomerates of yesteryear. They must be broken up," writes Sebastian Mallaby in an article in the *Financial Times*. "The best minds in academia and government have grappled with the challenge of too-big-to-fail." [15] That's true but the deliverables have fallen short of a solution.

Mallaby's thesis is that the Libor scam should not be looked at as an isolated incident. It's part of the banking industry's strategy to squeeze profits out of everything and forget about the ethics. Such a policy is akin to that followed prior to 2007 when financial institutions held securitized mortgages and other derivatives in supposedly segregated companies, which they:

- Rescued when they crashed,
- And when the big banks themselves started falling off the cliff, they were rescued by lavish amounts of taxpayer money.

The same story in greed and lack of ethics has been repeated with the manipulation of Libor. The wrongdoers knew very well what they were doing. As an article in the *Financial Times* reported, the CFTC settlement papers made reference to a senior Barclays manager who in 2008 told an official of the British Bankers Association (BBA) that his institution had not submitted totally accurate accounts: "We're clean, but we're dirty-clean." The BBA representative allegedly responded: "No one's clean-clean."[16]

The cost of the "dirty-clean" subprimes, rate-fixings, and other scams have to be viewed not only in ethical terms but also in conjunction with the financial stresses that followed, and have been largely borne by the working classes. With the Libor scam it turns out that the banks that were gambling with the taxpayer's money were also selling their clients other fraudulent instruments whose interest rate costs were manipulated to serve the bankers' bonuses.

Financial scandals have their origin in the spirit that says: "I am above society and I am untouchable. Therefore I can do whatever I like." Under that same wrong-way spirit also come heavy losses because of pure gambles. When JPMorgan Chase confessed that one of its London traders—the so-called London whale—had lost $2.5 billion, the supervisory authorities were not sure how to act. Financial regulations have not been up to the mark.

Neither do banking and finance have the exclusive copyright for embarrassing disrepute. When it comes to scandals athletics, too, competes for the highest score. FIFA, football's governing body, was guilty of ethical misdemeanors of millions of dollars paid to Jaao Havelange, the organization's former president, and Riccardo Teixeira, the former head of Brazilian football, as revealed by a report drawn up by a Swiss prosecutor.

The document on the FIFA scandal was published for the first time on July 11, 2012, having been suppressed since 2010, after the two individuals reached a deal to end the criminal investigation. The Swiss federal court ordered the report's publication, and its contents described FIFA as a deficient organization in its enterprise (its) knowledge of the bribery payments to persons within its organs is not questioned. Also not questioned are other scams, for instance, ones concerning derivative financial instruments or, if you prefer, gold mines (section 5).

4. Risk Appetite, Derivatives, and Bank-to-Bank Exposure

"For Western banks," said an article in *The Economist*, "the uncomfortable parallel is with their Japanese peers' slow recovery. American and British banks at least seem to have grasped the main lesson: that it is vital to deal with bad debts fast. Some continental European banks have been more sluggish in cleansing their balance sheets. The Japanese banks wasted a decade running away from reality."[17]

It should also be added that increasing the bank-to-bank exposure with derivative financial instruments was a wrong-way course that repeated itself in most of the leading economies. Statistics released by the Bank for International Settlements indicate that the banks' risks in derivatives vis-à-vis other banks tapered off right after the crisis, then it continued to increase. This is particularly true with:

- Interest rate risk, where transactions can run up to 30 years, and
- Currency exchange risk, which is shorter term but the amounts are staggering.

In notional principal, more than 85 percent of currency exchange–related exposures of many financial institutions is interbank transactions. (Notional principal amount is a widely used term borrowed from swaps trades. It indicates capital that will not necessarily be paid as such but constitutes a frame of reference in regard to a commitment being made.)

Statistics on interest rate and forex deals are way up from the early years of derivatives trading, when 50 percent of exposure was still bank-to-bank. A higher level of exposure talks volumes about the increase in *risk appetite,* the generally accepted meaning of which is the willingness of investors and speculators to bear financial risk with the expectation of a potentially major profit. A rise in risk appetite affects:

- Investor confidence,
- Investor sentiment,
- Risk premiums,
- Market liquidity,
- Volatility in asset prices, and
- Other economically important events.

Risk appetite is often hidden behind over the counter (OTC) trades that banks keep close to their chest, but are generally believed to represent a great amount of exposure. Many of the instruments traded over the counter are custom-made and they are so esoteric that regulators don't even venture measuring the risk embedded in them—a reason why they would like to see them traded and cleared in exchanges, the so-called central counterparties (CCPs).[18]

The opposite of risk appetite is *risk aversion,* which impacts the subjective attitude of investors toward uncertainty and, through it, their preferences in terms of risk and return. Risk aversion also depends on the overall market psychology, which makes small game of fundamental factors that should, at least theoretically, drive asset prices.

Regulators as well as many auditors advise banks to be cautious. They point out that the market for toxic assets has been fairly thin, suggesting that *write-ups* (price increases) in some inventoried toxic assets whose value has been written-down could be short-lived, and a reversal would force banks to further *write-downs*.

Risk control is a major instrument promoting efficiency and ethical behavior in a market economy. Chief financial officers should be very reluctant to mark up assets based on simply a few trades, a frequent happening bordering on creative accounting. Internal regulations set by the board should make it more difficult to book a gain through write-ups largely due to an entity's risk appetite.

Insider trading (chapter 6) is another manifestation of risk appetite. While it is today illegal in many jurisdictions people and companies are innovative. In late 2010, for example, exchange-traded funds (ETFs, section 6) have emerged for maximizing gains in one stock while potentially masking trading patterns.

For instance, a speculator could acquire information about a company, buying an ETF that includes the company's stock and short sell the other stocks in the ETF. Known as *ETF-stripping*, this practice allows him to benefit from movements in the company's share without visibly buying or selling its equity.

Plenty of risk appetite is embedded in the *DuPont identity,* which holds that return on equity (ROE) can only rise through increases in asset intensity, margins, and gearing, demonstrating the pressure. Exactly for this reason, regulators have lifted capital requirements for the more leveraged parts of banking like derivatives and credit trading. Moreover, with Basel III, stricter rules surrounding collateralization are aimed to keep risk-taking within acceptable bounds. Banks object, saying that these will lead to declines in volumes and volatility, hurting revenues.

Other examples of transactions devised for quick profits revolve around globalization and its contagion risk which, at least theoretically, could be hedged through derivatives. The globalization of financial markets, and, therefore, of risk and reward, are by no means recent phenomena. As early as 1875 watching stock markets falling everywhere, Carl Meyer von Rothschild described how the "whole world has become a city." What has greatly changed is:

- The nature of the instruments being globally traded, and
- The amount of exposure these represent for their holder and the financial system.

Risk aside, the fair value of these instruments is difficult to extract through current methods, except when they have an active market and their fair market value can be used as proxy. (*Fair value* is the amount a willing buyer will pay a willing seller under no fire-sale conditions.) The visibility of fair value associated with novel derivative products is generally low because of a great deal of uncertainty about the complexity of their design and the fact that:

- They get more sophisticated nearly every day,
- But after being bought the market for them is practically nonexistent.

Neither are there any rules on how much exposure with derivative instruments should a bank take to avoid very bad surprises in the future. Some years ago, one of the institutions contributing to my research said that its policy was to ensure no more exposure in derivatives than the previous year's profits. The idea is not unsound; the problem is that of applying it.

- How do you establish such a limit?
- How do you measure it daily? Or even better intraday?
- How do you put the brakes to keep the level of exposure at last year's profits?
- How do you make sure that a new management is not doing away with that policy, subsequently taking inordinate risks?

This is precisely what has happened to plenty of banks. After the more prudent CEO retired, his successor reversed the risk control policy, giving free rein to his traders. They, in turn, produced good profits for the first couple of years, and got outstanding bonuses. But with a blank check at their disposal they overplayed their hand, and a year later the losses were higher than Mount Everest.

This does not mean that a good risk control system will make the bank fail-safe, but having a goal and a limit in exposure is the better way to bet. The complexities and interdependencies inherently associated with novel derivatives are such that a sudden failure of a major market player might disrupt the financial system. Even smaller shocks have a negative aftermath. On September 21, 2010, Deutsche Bank's equity lost 8 percent at the Frankfurt stock exchange because market participants became privy to news they did not like.

There are also cases of conflicts of interest and of premeditated illegal transactions. According to law enforcement officials, catching a thief increasingly requires unconventional tactics because speculators have become sophisticated. An example is the so-called *mosaic theory*, whereby investors gather large volumes of data to arrive at conclusions that look like they might be derived from insider trading and can be used as a legal defense.

Even the legitimate hedging of risk with derivatives can turn on its head. In mid-February 2010 AngloGold Ashanti, the world's third-largest gold miner, commented that in the course of the previous year it had continued to free itself of its toxic gold hedge book and this helped to narrow its annual pretax loss to $153 million given the strong gold prices in the fourth quarter. Still, at the time of the 2004 merger of AngloGold with Ashanti Goldfields, the combined company's hedge book had sold gold at prices significantly lower than a spot price that was buoyant in 2009.

The combined effect of being leveraged and misjudging the direction of the market is one of the major risks with futures and forwards. Wrong-way hedging is a proof for many that risk management is an art and not a science. The few institutions that know how to manage risk appreciate that excellence in risk management is like pretrial preparation by criminal law attorneys. The functions of investigative risk management include the vital arts of:

- Thorough preparation,
- Detailed investigation,
- Examination and cross-examination, and
- Distillation and summation.

This is followed by presentation of risk measurement and projections to top management in a convincing manner, based on factual evidence, and containing an appreciation of individual risks as well as a holistic approach comparing the entity's exposure to its capital, liquidity, and financial staying power. By thinking the unthinkable bankers and investors should pay more attention to prudential risk control than to an inordinate amount of profits.

5. Bre-X and Other Gold Scams

With an estimated 175 million ounces of gold, worth $215 billion (at current prices), changing hands daily in the OTC market, it has been practically unavoidable that scams would spring up left, right, and center. On December 13, 2013, came the news that BaFin, Germany's financial regulator, demanded documents from Deutsche Bank as part of an investigation into the potential manipulation of gold and silver prices.[19]

This probe came as regulators stepped up the scrutiny of benchmarks, after several global banks were punished with heavy fines for the Libor scandal. Deutsche Bank is one of five institutions that take part in the twice-daily "London gold fixing." The other four banks are Barclays, Bank of Nova Scotia, HSBC, and Société Générale. There is also a trio comprising Deutsche Bank, HSBC, and Bank of Nova Scotia that decides on silver price fixing. Practically, however, the decision maker is the invisible hand of the big central banks.

Between January 2010 and December 2013 global gold prices may have been manipulated on 50 percent of the time according to an analysis by Fideres, a consultancy.[20] In its research on market behavior Fideres found that gold price frequently climbs (or falls) once the twice-daily conference call between the five banks begins. Both peaks and troughs are sensitive to these pricing decisions.

- First, prices react almost exactly as the call ends,
- Then, they experience a sharp reversal; the researchers alleged that this pattern may be evidence of collusive behavior.

According to market sources, gold price manipulation is a much bigger case than the Libor scandal. Dr. Paul Craig Roberts, formerly US Treasury's assistant secretary and currently associate editor of the *Wall Street Journal*, suggested in a TV interview that the famed 8,000 tons of gold at Fort Knox have changed residence. Nobody is sure what has happened and why. The market thinks that most likely:

- They have been lent out to big banks as collateral for their huge toxic positions, and
- At least part of the lot has been used to swamp gold price in the market as unconfirmed reports suggest that it is in Fed's interest to do so.

The fact is that when Berlin asked to repatriate 1,500 tons of gold, all it got from Washington was a confirmation of 300 tons over seven years, starting with only 9 tons in 2013.[21] This was followed by a presidential veto for the auditing of the Fed by the Government Accountability Office (GAO) of the US Congress, leading market watchers to believe that something is quite wrong with the American economy. Anything can happen when nobody is allowed to check the numbers.

* * *

While London is the global center for gold trading, it is interesting that the first to move with an investigation of the gold price scandal was Germany's BaFin rather than Britain's Financial Conduct Authority (FCA) which has also been looking at precious metals as part of a broader review of financial benchmarks. The London gold fixing has been a benchmark for the market since the end of World War I. In the intervening years, there have been other scandals relating to the precious metal, often in connection with fake discoveries of new huge gold deposits. Bre-X is one of the most glaring of scandals.

In December 1996, when the stock of Bre-X Minerals began sliding from its September high, brokers still strongly recommended a *buy* on what they characterized as being "the gold recovery of the century." Bre-X's Busang gold discovery "is enormous," Lehman Brothers advised, adding that it expected this "growth story to continue in a major way for the rest of this decade."[22]

By April 1997, Bre-X stock was off nearly 90 percent from its peak, and available evidence suggested that Busang, its famed site, did not contain any gold worth mining at all. This sort of gold scandals connected to discoveries were not new; they extended far beyond Bre-X and became the killing fields of the late 1990s while:

- Canada emerged as a financial center of a global mining exploration, and
- The boom of "exceptional" gold fields extended from the former Soviet Union to the Peruvian Andes and the jungles of Indonesia.

The common pattern of gold scams has been that hundreds of so-called junior mining companies, such as Bre-X, sparked a rush to join the bandwagon till many investors were burned by the ensuing debacle. When Bre-X shares plunged to $2 they took the company's market value to $480 million, way down from its peak of over $5 billion. Investors claimed fraud, joining in a shareholder class action against Bre-X, its officers, and Kilborn Pacific Engineering. The class action was filed by Houston-based law firm Baker & Botts, which added an international perspective.

Some investors have been saying that they were talked into bad deals by big banks. Take as an example JP Morgan, which has acted as Bre-X's key financial adviser since September 1996. In February 1997 Morgan bankers promoted Busang in conference calls in which Bre-X's top geologist predicted the deposit might contain a staggering 200 million ounces of gold, worth over $70 billion at that time's prices.

Analysts said that also startling was how many of the experts in the gold business placed their faith in the drilling reports by a rather obscure company based in Calgary, Alberta—a firm that had never mined an ounce of gold. A further irony was that Placer Dome and Barrick Gold were never allowed to do their own drilling to validate these reports, yet the rush of investors to be part of the $70 billion one in a lifetime business opportunity continued unabated almost till the day of reckoning.

Gold that has already been mined and is inventoried in well-guarded vaults is also subject to manipulations for quick profits. The name of the game is the gold carry trade promoted by gold leasing operations. Without surrendering the title to *their* gold, central banks have been leasing their gold reserves to selected international banks, known as *bullion banks*. Gold in central bank vaults earns no interest, and leasing offers a small return on otherwise idle assets.

- The leases are typically for three-month periods, and
- The risk taken by the speculators is that the market in gold turns the other way.

The bullion banks usually loan the leased central bank gold, largely for speculation, either to hedge funds or to gold mining companies faced with the falling world gold price. Hedge funds and gold mines sell the physical gold for dollars, giving banks cash that could be used to buy other instruments, for instance, government bonds (when their interest rate is high). Then, they use these government bonds as collateral to buy more speculative stocks on margin.

Such transactions have been increasingly combined with exotic customized derivatives sold by the bullion banks to their friendly hedge fund and gold mining clients. It comes as no surprise that the banks which in the 1990s lent Long-Term Capital Management (LTCM) billions to super-leverage its speculative bets, have been the same behind the gold carry trade; a list which included JPMorgan, Goldman Sachs, Chase Manhattan, Deutsche Bank and more.

But like in the case of the yen carry trade where bets are taken by hedge funds, banks, and others gambling that the Japanese yen would never again rise against the dollar, when market events suddenly reverse, the gains from gold carry trade are torn up and replaced by red ink. As every speculator rushes to exit from the same door, it becomes quite difficult for hedge funds to come up with physical gold to repay the banks and, ultimately, the central banks that lease the gold in the first place. Even gold mines are caught in the swing.[23]

6. Exchange-Traded Funds

Exchange-traded funds (ETFs) are financial instruments that have opened up new ways for investments. Their advantages lie in the fact that they are easy to trade and not so expensive. They can generally model a target index physically or synthetically. With physical replication, ETFs try to emulate index movements based on their basket of securities indexes or commodities; performance aims to be equivalent to that of the basket. The downside of ETFs is lack of transparency in their management.

ETFs using physical replication to track the yield path of illiquid assets are becoming increasingly popular, enjoying higher trading volumes and narrower spreads than the underlying securities. Synthetic ETFs use a swap contract to exchange the performance of the basket of securities for that of the reference index. Created in March 1990, the first ever ETF was the Toronto 35 Index Participation Fund.

There exist ETF commodity, forward commodity, short commodity, leveraged commodity, basic metals, precious metals, oil, and other securities. Market makers can net sales and purchases of ETF shares in the secondary market without having to trade the underlying securities. The resulting cost advantage is dictated by the volumes traded in the secondary market.

Because they provide a relatively easy way to trade for the large number of investors, assets under management in exchange-traded funds have grown rapidly in the past few years. At the end of 2012, global assets managed by ETFs stood at nearly $2 trillion—with Europe-based funds accounting for about 20 percent of this total. This represented an increase of 30 percent in 2012.

ETF fees and expenses are often lower than their traditional index fund counterparts, but they are not zero. Sometimes ETF providers are able to generate additional income by lending securities and by charging customers the normal bid-ask spread, while actually executing at much tighter spreads by crossing or exploiting efficiencies in their trade execution platforms.

In the secondary market, investors deal either directly with an ETF provider or on a stock exchange in which providers and other market makers operate. The secondary market is typically employed by authorized participants to relay to investors the price and other information resulting from the primary market.

Promoters of ETF securities, like SPDR and iShares, usually issue reports that focus on cumulative total return (usually for three, five, and ten years) and average annual return. In reading these reports investors must remember that the performance being quoted represents past events, and they are no guarantee of future results. Investment return and principal value will fluctuate, so one may have a gain or loss when ETF shares are sold. Neither do the returns reflect the deduction of taxes that an investor would pay on:

- Fund distributions, or
- The redemption or sale of ETF shares.

In addition, it is doubtful whether the liquidity of ETFs can decouple from the liquidity of reference assets without exposing the financial institutions involved in this redemption process to higher risks. Intermediaries promising a constant redemption of unit shares against cash run the risk of:

- Accumulating illiquid assets, and
- Recording liquidity outflows, exposing their position particularly in time of increased withdrawals.

Authorized ETF participants may pass liquidity risk to the investors, for instance, by only accepting the unit shares at a significant discount to net asset value. Alternatively, increased redemptions of ETF shares may cause a market maker to reach internal risk limits owing to the cash collateral requested by ETF providers. Or, the authorized participant may be forced to accept share redemptions from investors only after he has been able to improve his own exposure.

Investors should moreover appreciate that not all ETFs are fail-safe. Some inverse and leveraged ETFs, especially those that track a geared multiple or inverse of an index, have failed to map their benchmarks. Investors also need to assess the risk that the provider may fail to meet local regulatory requirements, or there exist regulatory breaches that may turn out to be quite costly.

During the so-called flash crash market turmoil of May 2010, the Dow Jones Industrial Average briefly dropped 1,000 points as liquidity evaporated. In the aftermath, about 65 percent of the trades that subsequently had to be cancelled were ETFs. Another risk concerns a change in the ETFs' nature.

Early exchange-traded funds that tended to replicate an index were transparent enough. But as the industry expanded into illiquid assets it pushed synthetic ETFs based on derivative deals. This change in the nature of ETFs exposed the investor to risks that he or she does not understand. For instance, investors can find that they acquired diverse, incompatible, and leveraged assets, rather than the portfolio they expected to get.

In addition, some new types of ETFs no longer offer the low cost, transparency, and diversification of the early varieties. Instead they have become a means for hedge funds to speculate in the market, allowing them to make complex bets on illiquid asset classes. Such deals may have an investment bank or some other hedge fund as counterparty; they can also be quite leveraged.

Leveraged ETFs have the ability to use combinations of financial contracts, such as futures contracts, forward options, or swaps to provide the targeted daily market exposure. The downside is complexity, opaqueness, and the fact that these ETFs do not actually purchase the underlying securities that comprise an index. Rather, they structure the desired market exposure entirely through swap agreements.

Quite often, investors are lulled into thinking leveraged ETFs are structured to track multiples of benchmark long-term returns. That's precisely the sort of deals to avoid. The so-called protection mechanisms used by ETF intermediaries can increase the likelihood of contagion in the ETF market. It is therefore important to provide investors in synthetic ETFs with more information on:

- The type of collateral by counterparties,
- Risk of a counterparty's default, and
- Effect of the above two variables on returns.

Furthermore, investors will be well advised to ask for information on whether synthetic ETF providers are be required to hold collateral that closely matches the assets of the index an ETF aims to track. For example, synthetic ETFs may hold as collateral Japanese shares for a fund tracking a European stock index.

Other important information is whether the ETF provider engages in securities lending, whether any lending revenue is shared with lending agents, what collateral the provider accepts, and how any cash collateral is reinvested. Another question to ask is whether there exist limits on the amount of assets that can be lent by an ETF. For greater efficiency, investors should be provided with accurate and timely data for:

- Selecting the right benchmark,
- Choosing the most appropriate investment vehicle, and
- Finding the best points of entry and exit from the ETF.

Last but not least, from a financial stability viewpoint, the fact that the ETF intermediaries succeeded in limiting their risks in the case of stress, is welcome. However, this may well be detrimental for investors, who, in some cases, have to accept high discounts to the net asset value. Investors should therefore remember that in times of market tension the liquidity of an ETF can indeed be lower than that of the underlyings; the collateral may be inadequate; or there may be deficiencies working to their disadvantage.

8

The Strategy of Financial Gambling

1. MF Global

With listed assets of $41 billion, MF Global is a large American broker-dealer headed, since 2000, by Jon S. Corzine, a former chairman of Goldman Sachs as well as ex-senator and ex-governor of New Jersey. Announced on October 31, 2011, the bankruptcy of MF Global has been the biggest failure of a financial company in America since 2008.

After becoming the company's chief executive, Corzine built up its trading activities and oversaw MF Global's bets in Euroland's sovereign debt market that eventually brought the broker-dealer against the wall. On November 1, 2011, the day after the news of the bankruptcy became public, many analysts said that while that company was no Lehman Brothers it did not mean the financial world and the US economy had been spared another Lehman-like moment.

Indeed, the day after MF Global filed for bankruptcy, equity indices were down anywhere between 2 and 6 percent, while the yields on bonds issued by southern Euroland countries, the objects of the broker-dealer's speculation, zoomed. MF Global's demise was a nasty reminder that Greek, Italian, Spanish, and Portuguese finances were anything but reassuring. Neither did the worry list end with these Euroland member states. Economic data from America were unexciting, while Brazil's industrial production had fallen.

In the wake of MF's bankruptcy, US regulators have considered limiting how futures brokers use customer funds. The debacle also revived calls for stronger broker oversight. The company was one of the largest global commodity brokers, with leading positions, by volumes, on Nymex and Comex, where energy and metals futures are traded. It was also one of 12 firms authorized to trade on the London Metal Exchange.

The position taken by the Commodity Futures Trading Commission (CFTC) was that Corzine had been negligent in failing to supervise the staff who worked in MF Global's office in Chicago. The result of light supervision was not only that the firm got into trouble and eventually collapsed, but also that it left behind a $1.6 billion hole in customer funds after allegedly dipping into clients' accounts to make up for part of its own funding shortfall.[1]

Neither was the broker-dealer's gambling strategy well-tuned. Rather it resembled Louis XIV's dictum "Après moi le déluge." At the time MF Global declared bankruptcy it was making wrong-way bets of billions of dollars on Euroland's government debts, particularly those of profligate member states. In addition, according to a government report, shortly before the company went under it had transferred $200 million from a customer account to cover a $175 million overdraft.[2]

In early December 2011, Jon Corzine had stated in a US Senate Agriculture Committee hearing that he never gave instructions that could have been misinterpreted as permission to misuse customer funds. He also pressed the point that he never intended to break rules about keeping customer funds segregated from the firm's money, but an employee may have misinterpreted instructions to try to save MF Global.[3] It is always the *lampiste* who does something wrong.[4]

Courts in many jurisdictions were expected to be involved in sorting out billions of dollars in claims. It is also interesting to recall that MF's demise came less than two years after it was intentionally transformed from a typically dull broker to an ambitious investment bank. The agent of change was the boss. Jon Corzine applied what he knew from investment banking and after he took charge of MF Global there came a series of positive news. The New York Federal Reserve Bank admitted the company into a select club of primary dealers in government debt. But Corzine was also taking risks with his firm's balance sheet which in a way were offsetting a slowdown in brokerage, but in another way were accumulating exposure.

Excessive leverage and proprietary bets finally burned up the company. The most deadly gamble was reportedly a big leveraged bet on the bonds of Italy and Spain. Taken together, these transactions exceeded $6 billion, promising "large profits at little risk." That turned out to be a deadly wrong hypothesis.

Michael Roseman, who had been, from 2008 until he was replaced in January 2011, MF Global's chief risk management officer, deposed to a House investigations subcommittee that the firm's positions in debt issues of troubled European sovereigns steadily increased from less than $500 million in March 2010 to nearly $2 billion in September 2011. Having seen this trend, he:

- Began to suggest caution on the growing liquidity, and
- Expressed his increasing concern with regard to the growing positions of concentrated exposure.

With no action taken to put a limit to exposure and diversify risk, within a month those positions grew to nearly $4 billion. The former chief officer said in his deposition that he was requested by the company's executives to ask the board of directors for authorization to increase the broker's limit on futures to $4.75 billion.[5]

The first evidence that something was seriously wrong emerged in September 2011 when the US Financial Industry Regulatory Authority, an autonomous agency once tied to the major exchanges, told MF Global to increase its capital. Four months later Moody's downgraded the firm, citing as reasons its capital and operating environment. Within a week of disclosing a quarterly loss, banks and exchanges had stopped doing business directly with the broker-dealer.

After that tandem of bad news, the hope of pulling the firm up from under rested on an agreement to sell it or shore it up—to be done in a hurry, preferably over the weekend. That possibility disappeared when more than $700 million of customer funds could not be found. Regulators unraveled MF Global's books, trying to account for the shortfall. CFTC and the Securities and Exchange Commission said that MF Global had reported "possible deficiencies in customer futures segregated accounts held at the firm."[6]

In Wall Street jargon this means that the broker had failed to meet rules on segregated accounts, thereby violating the funds' separation guidelines by the Commodity Futures Trading Commission. That has been another negative that dashed the eleventh- hour attempt to save the firm from bankruptcy. On November 17, 2013, MF Global was ordered to pay $1.21 billion restitution to corporate clients.[7]

An inordinate amount of exposure was all over the place. MF Global had an outsized share in Australian commodities markets, where its customers accounted for more than 80 percent of the turnover in the country's wool contracts. After the MF Global collapse, ASX, the Australian exchange operator, shut down the country's agricultural commodities market. The move highlighted the impact that the bankruptcy of the American broker had on futures markets.

In a notice, the ASX stated: "Given the significant percentage of open interest held by (MF Global) in order to maintain a fair, orderly and transparent market, the agricultural markets for grain and wool have been suspended until further notice."[8] In the US, as they probed missing customer funds at MF Global, regulators have been prodded by investors to adopt cleared swaps. (That's a form of derivatives contract negotiated between two traders where the risk of one party defaulting is shifted to a clearing house.)

The case of cleared swaps, which in the meantime has advanced promoted by ISDA and regulators, did pose a fairness problem, leading to a debate as to whether the same rules should apply to both swaps and futures. It was feared that the latter might provoke a backlash from the futures industry, which is protective of the status quo. Indeed, it is not possible to justify adding protections for swap customers that are not going to apply for futures customers.

2. The Dexia Group

In its heydays, and in a way reminiscent of Ivar Kreuger's wrong-way policies (chapter 6), the Franco-Belgian Dexia group was a large lender to European sovereigns and subnationals. Another dubious "honor" claimed by Dexia is that in the short span of five years (2008–2013) it went bankrupt twice.

Once the world's largest municipal lender, Dexia was one of the first European banks to be hit by the American subprime mortgages meltdown. A second big hit came in sequel to Euroland's sovereign debt crisis, as Europe's debt woes further darkened Dexia's prospects, forcing the new owners of the nationalized bank to extend their financial guarantees, while as a going concern Dexia was characterized as the largest "bad bank" in the EU.

On February 21, 2013, the Brussels-based financial institution said that in 2012 it had suffered net losses of €2.9 billion ($3.9 billion). This came just a year after its 2011 losses of €11.6 billion ($15.6 billion). The river of red ink led to the dismantling of the lender, a condition for its second bailout. Dexia was forced to sell its stake in Turkey's Denizbank (to Russia's Sberbank), its Luxembourgish private banking unit, and its French public lending arm.

Subsequent to these sales of assets, Dexia was split up and partially nationalized by France and Belgium, its major domicile countries, while the European Commission (EC) approved the bank's resolution plan. The plan was submitted in December 2012 by the governments of Belgium, France, and Luxembourg.

The move did not leave the three countries' taxpayers off the hook. Belgium, France, and Luxembourg provided a funding guarantee on liquidity for the remaining longer-term assets. Other assets including Dexia Belgium, Banque Internationale de Luxembourg (BIL), DKB Polska, and Dexia Asset Management have been divested, with the remaining entities to be sold or wound down.

According to analysts, Dexia's mismanagement has been a very costly affair for the French and Belgian sovereigns, particularly the former. Already the big, untidy bank's salvage in the fall of 2008, following the Lehman Brothers bankruptcy, had a price tag of €6.6 billion ($8.9 billion), paid by the French taxpayer, and another huge amount to the charge of the Belgian taxpayer.

In spite of that lavish money, or more likely because of it, Dexia continued to practice "après moi le deluge." Soon it became evident that the capital contributed to its treasury by misguided, soft wax governments was not sufficient, given the bank's increasing liabilities. An article published in *Temoignage Chrétien* on March 18, 2013, by Gaël Giraud advanced the estimate of €85 billion ($114.7 billion) in charge of the French sovereign, in a worst case scenario spanning the four decades Dexia's obligations are expected to last.[9]

In compliance with the salvage plan and in order to get some hard currency, Dexia sold its 99.9 percent holding in Banque Internationale de Luxembourg to Precision Capital (90 percent)[10] and the Luxembourg sovereign (the other 10 percent). BIL dates back to 1856, when it was founded as Luxembourg's first bank, and it is presently active in retail banking, private banking, corporate banking, and the capital market. Renamed Belfius, Dexia's Belgian operations are now 100 percent controlled by the Brussels government. That outfit seems to be profitable and is slated for refloatation in 2015, if it continues to keep out of the red ink.

Also by way of disinvestment, the Dexia Group sold its stake in Dexia Municipal Agency (Dexia MA) to Société de Financement Local (SFIL), a newly established French development bank dedicated to financing French local authorities and the public health sector. Some 75 percent in SFIL is owned by the French state; 20 percent by Caisse des Dépôts et Consignations; and 5 percent by La Banque Postale (including the option to increase its participation up to 33 percent of SFIL in the aftermath of new loans).

As with many other cases related to sovereign financing in France, the Caisse des Dépôts et Consignations acts as the key liquidity provider while the French state is committed to remaining a reference shareholder. A different way of looking at this issue is that SFIL acts as a service provider and holding company for Caisse Française de Financement Local

(CFFL), the former Dexia Municipal Agency, which is fully owned by SFIL. This is a complex structure but not unlike other similar solutions invented to hide the fact that at the end of the day all these salvages of big banks are made with public money.

3. Risks Associated with Securitized Portfolios

Dexia was overseen by French and Belgian regulators. Its escapades and travails document that the supervisory authorities of both countries did a miserable job. MF Global and Lehman Brothers were run as single entities, each being largely overseen in the US. Their disintegration caused rancor almost everywhere, and many blamed the American supervisors of having been lax in their duties.

The criticisms extended all the way to the lack of transborder collaboration among regulators. In the case of Lehman, Britain complained that the investment bank had been allowed to snatch $5 billion in cash from its London operation just days before its bankruptcy. Germany complained that the Bundesbank had been saddled with defaults on about €8 billion ($10.9 billion) of loans the central bank had made to the derelict investment bank's German subsidiary.

Regulators now say that they are doing their best to avoid a repeat. At the same time, however, but because they know the fragile state of their banks, they try to delay the implementation of Basel III rules, while governments are keen to water them down, turning them into paper tigers as well.

European banks are still undercapitalized and while their American peers may be better in terms of capital ratios, they are not much better. To improve their financial staying power, in 2014 European banks are set to issue an unprecedented amount of contingent convertible bonds (Cocos). These were created in sequel to the 2008 financial crisis to absorb the first major bank losses thereby avoiding the need for taxpayer bailouts.

Some Cocos can be written off entirely. Others convert into equity when a bank's capital ratio falls below a preestablished trigger. In 2013 an estimated $10 billion worth of Cocos was issued, but it is practically impossible to say if this is a significant amount or if it is too little, because the banks' real exposure is opaque even to the institution's own management. It is, also, elastic. Therefore, how much of the risk is being confronted through this new and rather curious form of capital is anyone's guess.

Neither is the advent of Cocos without controversy. Many investors criticize them for being too punitive for creditors. For instance, the so-called sudden death Cocos would enable a bank to write down the value of the bond while it:

- Still remains a going concern, and
- Continues to pay dividends to equity holders.

To a fairly significant extent, the Cocos evolution has been promoted by the record low interest rates that created demand among yield-starved investors. For instance, all Barclay's Cocos have been issued with coupons yielding between 7.6 percent and 8.25 percent, which is higher than the yield on most Barclays debt.[11]

Banks look at Cocos as saviors, but in all likelihood this market will be downgraded and it might dry up as soon as interest rates begin to rise. In the meantime, though they may not know it, investors are in for rude surprises as soon as the market dynamics change and the cost of money becomes respectable after having been for so many years under the silly zero interest rate policy. Three sources of risk will come to prominence with positive interest rates:

- Exposure inherent in securitized portfolios,
- Country risk associated with the weaker of sovereigns, and
- The urgent need for transborder regulations, which classically encounter formidable political obstacles.

Securitized portfolios are greatly exposed to financial losses as it may not be possible to refinance some loans due to mature in the next few years, including commercial mortgage-backed securities (CBMS) and residential mortgage-backed securities (RBMS) from the precrisis boom years.

This is not a criticism of securitization per se, but of the light way in which underlying assets are selected and included in securitized products. High quality securitization can play a positive role in financial markets. But this cannot be said of all securitized paper, the subprimes and Alt-As being among the worst examples of total irresponsibility.

The pros advice not to worry because the rules of securitization "have changed." They make reference to new regulations combined with banking industry initiatives, like the prime collateralized securities (PCS) label for high-quality securitizations. Theoretically, but only theoretically, these require and encourage:

- Better alignment of risk,
- Greater transparency, and
- Less reliance on credit ratings.

It sounds like manna from heaven, but all this is only as good as its application and, most importantly, its supervision. The revival of the securitization market requires practical evidence of high-quality instruments, which is still missing. Also most critical is an effective coordination of securitization regulation between global, regional, and national regulators, as well as policy makers. This, too, is not for tomorrow.

Market demand for a financial instrument does not revive at a command or through wishful thinking. A crucial rule is that of quality of supply as well as of volume. Experts believe that the refinancing problem will be made worse by the high proportion of loans that will have to be extended in the coming years, and by a drop in the receptiveness of securitization by the markets.

There is a reason why banks with an international perspective are trimming their holdings of CMBS, RMBS, student loans, car loans, credit card receivables, synthetic CDOs, and other securitizations. They use maturities, repayments, redemptions, and amortizations as well as net sales to drop their cumulative book value. Nowadays write-downs have relatively little effect on book value, contrary to what happened in 2008–2009 when they had a significant impact on the value of inventoried securitizations.

Behind this trimming down lies the fact that, in the present low–interest rate environment, uncertainty in capital markets and the resulting shift to tangible assets may cause a build-up of risks to financial stability. *If* this happens, *then* misallocations would be a real danger, with detrimental effects on rollover financing.

There exists as well the case of a new synergy between sovereign and banking industry risk. German and French credit institutions are the largest creditors to debtors in Spain, Portugal, Italy, and Greece. Though after the selective default of Greece, following the Private Sector Involvement (PSI), they have diminished their claims to a significant degree, even their reduced exposures to the Italian government and Spanish banks are striking.

- Claims on debtors in Italy stand at €96 billion ($130 billion), and
- In Spain claims on debtors is €82 billion ($111 billion); the two countries make, between themselves, the bulk of exposure.[12]

Looked at individually, Spanish banks are not that far from the edge of the precipice. In terms of refinanced-restructured loans, in mid-November 2013, Santander had outstanding loans valued at €32.9 billion ($44.5 billion). Of these loans about two-thirds were impaired or substandard (IorS); Caixabank was saddled with €25.4 billion ($34.3 billion) with roughly 60 percent IorS; BBVA, with €24.5 billion ($33.5 billion) with 72 percent IorS; Bankia, with €22.1 billion ($29.8 billion) with a large amount in IorS; and Sabadell €15.8 billion ($21.3 billion) of which nearly 55 percent IorS loans.[13]

Notice that most of the big Spanish banks have been active crossborder. The examples of substandard and ineffectual crossborder supervision of credit institutions are many. Dexia, which has been discussed in section 2, is one of them. Another case that tells an interesting story of how fast good fortune can change into bad fortune is that of Investicni a Postovni Banka (IPB), a premier credit institution of the Czech Republic. It was also the republic's third-largest bank, till a run on its deposits sucked it dry.

Analysts in Prague estimated that the bank's collapse hit the nation's gross domestic product hard in 2000 when this event took place. As efforts to negotiate a rescue with Nomura Europe, IPB's largest shareholder with a 46 percent stake, failed, the Czech Republic's central bank moved in to take control. This avoided a wider banking crisis in the Czech Republic, but the damage to the economy was already done.

As is often done in these cases, the government fired most of IPB's executives and agreed to sell the remains to its crosstown rival, Ceskoslovenska Obchidni Banka (CSOB), a unit of Belgium's Kreditbank (KBG), which guaranteed IPB's deposits and agreed to cover all its losses. IPB's collapse, however, sparked a growing scandal that renewed doubts about the stability of the Czech banking system.

Analysts said that in spite of KBG's takeover, the government's intervention in salvaging the depositors and covering some other liabilities of the failed institution could cost Czech taxpayers as much as $5.3 billion, or $530 for every man, woman, and child. "Just as things look like they are getting better in the Czech Republic, they get worse again," said Andrew Cowley, head of emerging markets investment strategy at Dresdner Kleinwort Benson in London.[14]

IPB had set up its own holding company, IPB Holding, but instead of directly transferring assets to it, it used intermediaries. Analysts said the bank somehow lost track of a considerable number of the shares in the process. In addition, it entered a series of option agreements, granting its counterparties, mainly holding companies, the right to keep their stakes or transfer them back to IPB.

This complex web of deals not only contributed to missing assets but also raised other questions. For instance, in February 2000, while depositors were already withdrawing their money, IPB granted a 30-day loan of $56 million to a unit of holding company Sekyra Group. Sekyra, which had annual sales of $25 million, used the money to buy a 56 percent stake in the Czech Republic's leading contractor; then it defaulted on the loan.

That sort of loans often find their way into securitized products, and weeding them out is not the remit of crossborder regulation and supervision. Neither is crossborder supervision able to confront and incorporate into its system rules and regulations that are largely political.

Standard Chartered became the subject of accusations that it hid transactions with Iran from regulators thereby evading US sanctions policy (section 4). The ING Bank has been confronted with allegations of illegally moving billions of dollars through the US financial system on behalf of Cuban and Iranian clients. Lloyds Bank, Crédit Suisse, and Barclays, among others, have been subject to investigations about doing business with Iran. As for HSBC the allegations have been that it inadvertently helped launder drug money and broke sanctions.[15]

4. Standard Chartered and the Iranian Deal

On August 6, 2012, New York state's Department of Financial Services (DFS), a new watchdog of the financial industry, accused Standard Chartered of hiding $250 billion of transactions with the Iranian government. The regulator issued an order that included a threat to revoke the bank's license to operate in New York state.

According to this order by the Department of Financial Services, between 2001 and 2010, StanChart concealed from US authorities about 60,000 transactions for Iranian clients, among them the Central Bank of Iran and two state-owned institutions, Bank Saderat and Bank Melli. This generated plenty of fees for the bank. DFS also said it had evidence that StanChart appeared to have conducted similar business schemes with Libya, Myanmar, and Sudan.

In mid-2012 Standard Chartered was the second British bank to face US criticism over alleged lax controls in moving money. In July that year HSBC was accused by a US Senate investigation of violating anti-money laundering rules. It was also stated that Deloitte & Touche, the certified public accountant, apparently aided the credit institution in withholding information from regulators in its independent report.

The legal advisers of Standard Chartered looked for ways to counteract the regulator's claims, prior to creating reputational damage. Peter Sands, the bank's chief executive, made no secret of the damage done to his institution. But the Department of Financial Services was not alone in its stand: the Department of Justice, FBI, Federal Reserve, US Treasury, and the Manhattan district attorney's office had all been pursuing investigations against StanChart for up to two years.

StanChart and DFS entered in negotiations about the size of the settlement. One of the early predictions was that it could exceed $500 million. In June 2012 ING had agreed to pay the US government $619 million to settle violations involving Iran (section 3). Allegedly Standard Chartered employees hid references connected to wire transfers to New York, in connection to Iranian government-owned institutions, by stripping out labels relating to Iran from wire instructions.

An article in the *Financial Times* by Frank Partnoy had this to say about the violations: "Decades ago, the general counsel of a bank thought more about ethics than efficiency. But today's in-house counsel are often profit centers, founts of wisdom on how to avoid accounting rules, cut taxes and maintain the secrecy of dubious practices…(being) more focused on speed and profit than on right and wrong."[16]

In an interview he gave to the *Financial Times* Peter Sands made a brief apology for the $14 million of transactions that his bank agreed were problematic. He insisted that any inaccuracies in facilitating these payments were inadvertent, adding that those were mistakes "and we're sorry they occurred."[17]

Incidentally the amount admitted by Sands represented the 0.1 percent of transactions on which StanChart itself had doubts while, according to its management, the other 99.9 percent the alleged sanction breaches were an erroneous classification by the regulator. Part of them were the so-called U-Turns transactions between non-US entities and Iran that could be cleared in New York, at least according to Sands.[18]

In the opinion of the StanChart CEO there were a whole range of inaccuracies and odd interpretations in the New York regulator's report, and his bank was contesting a lot of the points. Apart the basic contention that only $14 million and not $250 billion of transactions were questionable, some details, too, were wrong. This was evidently an argument with which the DFS did not agree, while insisting that Standard Chartered's actions were the result of a documented willingness of its most senior management to:

- Deceive regulators, and
- Violate US law.

According to the DFS, from 2001 Standard Chartered began doing business with the central bank of Iran on behalf of the National Iranian Oil Company (NIOC), which received $500 million a day in dollar payments.

Moreover, the Department of Financial Services insisted that Standard Chartered's deception was aided by Deloitte & Touche, the auditor. Deloitte had been hired by the bank in 2004 as a result of a prior settlement with regulators to provide an independent report on its compliance failures. On the contrary, always according to DFS's opinion, Deloitte:

- Provided Standard Chartered with confidential reports on other banks that gave it insights into how regulators were investigating Iranian transfers, and
- At the client's request it drafted a watered-down version of a report that deleted references to sensitive payments.[19]

In London George Osborne and Vince Cable, respectively the chancellor of the exchequer and business secretary of the Cameron government, resisted the urge to intervene in the row to avoid premature judgments over the accusations that the bank had concealed transactions with Iran. But behind the scenes there had been signs of discomfort about what was considered to be a virulent US regulatory probe into the British bank.

Critics of this massive number of US accusations about Iran deals said that Britain should start pricing its financial transactions in sterling or euros to stay out of reach of the American authorities. The critics included Boris Johnson, London's mayor, who said that he did not want to see a self-interest attack on London's status.[20]

There have also been critics of the global financial system and the way it works during the last three decades. They say that the DFS versus Standard Chartered case confirms that global banking is about making a fast buck regardless of ethics, beyond what is permitted by law, and independently of the interests of clients. The motto is profits and bonuses at any cost, including reputation.

In between the pros and the critics lie those who think that financial scandals at large eventually lead to fragmentation of the global system. The likelihood of this happening is increased by the fact that while finance is global, its regulation is primarily national, with national regulators being:

- Protective of their home-grown banks, but
- Aggressive with those based in other jurisdictions.

The epilogue to Standard Chartered travails in the particular case we are discussing, did not take long to come. On August 15, 2012, it agreed to pay $340 million fine to DFS. Among those who urged John Peace, the bank's chairman, to reach an agreement and avert a potentially bruising legal showdown with the regulator, were major shareholders. They thought that it made no sense to have a public fight that could drag on for months and undermine the bank's credibility.

Investors were also worried about DFS's threat to revoke StanChart's license, a concern shared by the bank's top management. Even if the regulator had no real intention of suspending the license, the perception that it might was corrosive. In the US Senate, Carl Levin, chairman of the Senate Permanent Subcommittee on Investigations, praised the DFS: "The agency…showed that holding a bank accountable for past misconduct doesn't need to take years of negotiation over the size of the penalty; it simply requires a regulator with backbone to act."[21]

5. The Prudential Securities Scandal

What might have happened with StanChart is exemplified by the case of Prudential Securities.[22] Starting in the 1980s, and over many years, this company faced troubles that dragged down its finances and damaged its image. During the time George L. Ball was its CEO, the broker-dealer sold an amount greater than $6 billion, which was big money at that time, in limited partnerships (LPs) to more than 100,000 investors.

Stiff up-front fees and commissions as well as plummeting values of the underlying investments took their toll. Half the investors' money was gone as by early 1991 these partnerships were worth less than $3 billion. According to the plaintiff's attorneys, Prudential Securities was named in over one hundred lawsuits claiming more than $2 billion in damages.

This has been one of the costliest financial scandals in Wall Street's history involving the stock broker owned by Prudential Insurance, one of America's oldest and respected life insurance companies. Critics said that those who sold billions of dollars of worthless investments to hundreds of thousands of Americans were not agents of the parent company but of Bache & Co, bought by Prudential after it risked going under because it got itself involved in the Hunt brothers' big time game aimed to corner the silver market. The implication was that the cultures of Prudential and of Bache were different.

- Past the silver market adventure investors were ruined by deals in financial paper that should never have been sold to them.
- Hounded by regulators, Prudential Bache renamed itself as Prudential Securities admitting in 1994, that it had for years distributed fraudulent literature in an effort to drum up sales.

Limited partnerships were supposedly a safe and tax-efficient form of investment that ruined both the broker and those who invested in them. Prudential Securities paid more than $1.4 billion in fines to regulators and compensation to investors. It has also been sued by dozens of its own brokers who complained that they were misled as badly as their customers. Unfortunately for Prudential Insurance, the parent company, the Prudential Bache scandal reverberated:

- Precipitating investigations into the insurer's sales culture, and
- Leading to sweeping changes in its top management.

To woo brokers into selling its LPs Prudential Securities used lavish incentives, including all expenses–paid trips to sought-out locations. It also employed a contest for superbrokers, which contributed to the company's earnings of more than $1 billion from fees and commissions generated by sales of limited partnerships, many of which turned out to be dogs.

This was the aftermath of the hard sales drive. In the decade of the 1980s, Prudential Bache brokers sold at least $1 billion of the total of $2.6 billion raised by Chicago-based VMS from eight publicly traded funds and more than one hundred private real estate partnerships. Then, as property values plunged, VMS stumbled. By 1991 its shares originally worth $10 traded as penny stocks.

More troubles came from investments in the energy sector. Some $323 million were raised from more than 27,000 investors in 1987 and 1988 for four blind-pool funds, G-1 through G-4. Prudential Securities and Graham Resources were the co-general partners. Marketed by Prudential as "vulture funds" to acquire energy-related properties and mortgages at deep discounts, the G-1 fund was never profitable while the G-2, G-3, and G-4 funds were saddled with loans to an offshore pipeline.

Lawsuits also came as an aftereffect of tricky investments developed with the Energy Income fund. An estimated $1.3 billion was raised by Prudential Securities from 121,000 investors, from 1983 to 1990, to buy oil- and natural gas–producing properties. Marketed as a high-yield, safe investment the fund's quarterly cash payout was cut to half while the partnership unit trade in secondary markets went from 60 cents to the dollar to eventually 10 cents.

As if all that was not enough, during the 1980s Prudential Securities became involved in a series of frauds and mishaps so incredible that they could be a comic opera. Tragedy and comedy, Socrates said, are the same thing and they should be written by the same author—and he was right.

In 1986, then chairman and CEO George L. Ball threw the Prudential Securities hat into the investment banking ring. This proved to be another disaster as the retail brokerage firm was starting almost from scratch, with little history and no clients in the viciously competitive investment banking. Never mind that the peak of the roaring 1980s had passed and the takeover business was no more exploding. Ball was eager to carve for his company a piece of the action:

- Hiring a lot of investment bankers all at once,
- Offering them top dollars, and
- Hoping that they would attract blue-chip clients.

But Prudential Securities was unsuccessful in brokering large investment banking deals and never came close to its goal of breaking into the elite ranks of the top five firms. "You can hire bankers, but you can't buy the business. You have to build it," said an investment analyst. "Other firms succeeded by starting small and adding people to match the growth in their business. It was an ill-conceived strategy, and it was not executed properly. They were spinning their wheels visiting IBM, when they never had a chance of going head-to-head with Goldman Sachs and Morgan Stanley."[23]

It did not take long to find out that this new foray into investment deal–making went from bad to worst. In 1988, two years after it started, it completed deals of $5,4 billion—including mergers, spin-offs, and restructurings. That score ranked twentieth in the US investment industry. Then in 1989 Prudential Bache dropped to the twenty-fourth position and in 1990 to the forty-second position with only $1.0 billion in deals. With this all hell broke loose.

Financial analysts said that not only was the original strategy flawed but its execution was also dismal. After making $110 million in 1988, Prudential Securities lost $51 million in 1989 and $100 million in the first nine months of 1990. Following these dismal results, Prudential Bache Securities withdrew from any meaningful presence in investment banking. The CEO announced the head of the investment bank was resigning and major staff reductions were needed because of losses suffered by the unit over the aforementioned period.

Of 180 investment bankers, about 120 were laid off. The cutback came at a time when Prudential Insurance, the parent company, was tightening its grip on its Wall Street subsidiary. The foray into investment banking was ill conceived, but Prudential Securities was also hard hit by the shrinkage of the mergers and acquisitions business. Hence the project initiated by Prudential chairman Robert C. Winters that focused on a three-year mission to install a top-to-bottom system of integrated internal controls, and overhaul the corporate culture so that serious marketing mistakes will not be repeated. The results left much to be wanted and this finally took Prudential Securities out of the broker-dealer ring.

6. A Class Action on Securities Lending

One of the major failures in the restructuring of Prudential Securities is that little was done to clean up another source of scandals, that of securities lending practices. Most brokers-dealers follow margin account securities lending policies, which do not exclude legal action by their clients from time to time. For instance, in mid-1993, 16 American securities firms were named in class action litigation involving:

- The industry's method of disclosure, and
- The manner of lending securities belonging to customers on margin.

In the aforementioned case, in order to avoid lengthy litigation a tentative settlement was reached requiring securities firms to provide clients with additional disclosure information concerning the lending of margin securities. This improved upon but did not alter wrong-way practices. The following text contains details of this litigation and the specific terms of the settlement.

William C. Rosenfeld and Warren E. Hart, individually and on behalf of all other similarly situated clients of securities houses, were the plaintiffs against the defendants who included Prudential Securities; Bear Stearns; Charles Schwab; Josephthal Lyon & Ross; Merrill Lynch; Dean Witter; PaineWebber; Kidder, Peabody; Spear, Leeds & Kellogg; Dillon, Reed; Sanford C. Bernstein; Neuberger & Berman; Wertheim Schroder; Fidelity Brokerage; Broadcort Capital; and Ernst & Company.

This class action has been on behalf of all individuals, corporations, partnerships, or entities of any kind who have or had a securities margin account, directly or indirectly, with or through the defendants listed in the preceding paragraph, any of their affiliates, or their respective predecessors.

The plaintiffs charged that the defendants' disclosure and manner of lending customer margin securities violated New York common law and, as a result thereof, the interests of plaintiffs and other members of the class they purported to represent were damaged. Therefore, the plaintiffs requested:

- A judgment declaring that the practice of lending margin securities violates New York law.
- An award of damages to each member of the class, for damages allegedly sustained, and
- A preliminary and permanent injunction barring the defendants from lending margin securities without improving disclosure regarding such practices.

For their part, the defendants specifically disclaimed and denied any liability or wrongdoing whatsoever with respect to all of the allegations contained in the complaint, asserting that the plaintiffs had authorized the defendants to lend their margin securities. Still, while rejecting the plaintiffs' claims to avoid further litigation the defendants let it be known that they did look for a settlement.

On February 17, 1995, the parties entered into a Stipulation of Settlement encompassing all causes of action, claims, or defenses. By an Order on Consent dated February 23, 1995, the Supreme Court of the State of New York conditionally certified the class for settlement purposes. The court's decision stipulated that within a reasonable period of time after the effective date of the settlement, the defendants would provide additional notice in the form provided in the Stipulation of Settlement:

- Either on or with an account statement sent to plaintiff customers,
- Or in a separate mailing to all current margin customers.

Prudential Insurance also had its own problems to follow up and find a solution. Along with New York Life, the state's fourth largest, they looked after settling cases involving sales practices. So did Metropolitan Life Insurance regarding plaintiffs' claims that its sales representatives misled customers about the so-called vanishing premium policies.

In late August 1999, Metropolitan Life accepted settlements up to $1.7 billion to settle suits by policyholders who had to pay for policies much more than their value.[24] MetLife's management admitted no wrongdoing as part of the settlement, but this case was another in a series of legal actions against top writers of life insurance, growing out of wrong sales practices. The insurer was accused of deceiving customers and policyholders about the characteristics of policies sold to them.

Other complaints about MetLife involved universal life insurance under which the policyholder could vary the premium or the death benefit. When interest rates were lower than projected, such policies required higher premiums or the death benefit fell. The company was also accused of persuading policyholders to surrender older policies and buy new ones incurring unnecessary additional sales charges, a process known as churning.

The common ground of all cases in sections 5 and 6 of this chapter is the intoxication associated with hard sales. It happens because new social forces come into the picture promoting novel financial products for which, by omission or commission, information is scanty and sometimes inaccurate. This helps to provide salesmen scattered over a territory with a coherence that (ironically) comes from absence of precision, but it is most unfavorable to the customers.

9

Barings: The Crashing of a Venerable Bank

1. Early History

The most depressing thing about the crushing of Barings is that while the bank's derivatives exposure had reached for the stars its top management believed that it had finally discovered a risk-free way of making profits. The bank assumed more and more exposure to options and other derivative financial instruments, while the evaluation of assumed risk was fuzzy or nonexistent. Toxic waste was interpreted as a sound investment and a secure good fortune—till all hell broke loose.

To better appreciate Barings' crash of 1995 it is advisable to start with the institution's history which begins in the mid-eighteenth century. From 1762 to 1828 it financed British and more generally European trade, helping in making England a great mercantile power. Then it expanded its operations to North America and eventually became known in London as the biggest "American house." Founded in 1762 it raised, till 1890, the then impressive sum of $500 million for various US loans and £40 million for Canadian lending.

That was a long call because, as financial history books say, both Barings and Rothschild began with modest resources. Francis Baring owned only a few thousand pounds when he started in banking but he had vision, drive, and valuable connections not only in Britain but also in France, Holland, and in the Baltic and Mediterranean countries. His secret for success was to find out a little more, a little earlier than his competitors.[1]

Fortune helped. In the early part of the nineteenth century, when Napoleon was gone after Waterloo and the Bourbons returned to Paris, the victorious allies demanded that France pays francs 700 million as indemnities for the past and another 150 million as guarantees for the future. Louis XVIII, too, wanted cash for his personal expenses, which led to Talleyrand's statement that the king had learned nothing (from the fate of Louis XVI) and he had forgotten nothing from past bad spending habits.

France had no money to pay for reparations. After the first installment the government was at the end of its financial resources, while ruthless taxation destroyed economic life. Barings and other banks filled the gap with loans financed by foreign investors, which hooked Paris on the debt trail. The French learned to live in a sea of red ink, a habit continuing unabated until today.

With its financial might on the rise, the Barings Bank was once described as the sixth great power of Europe, after Britain, France, Prussia, Austria, and Russia. For more than a century it was a profitable financial institution but by 1890 a rapid increase in the risks it had assumed, particularly in the US and Argentina, drove it to the edge of the precipice.

Half a century earlier, in the 1840s, Barings had the financial power and credit status of today's big global banks. Indeed, in 1839 it saved the Bank of England by contributing to the payment of all its bills and by assisting the sovereign's effort in reversing the central bank's decline. Half a century later the Bank of England repaid its moral debt when it helped Barings overcome *its* deep financial crisis.

Ironically, Barings' troubles started in 1839 when in a short timeframe (1839–1842) Maryland and Pennsylvania defaulted on their loans while other states and municipalities were in the sick list. The standing of American credit dived and the criticism of Barings loans to them spread in the City of London. *The Times* wrote that Anglo-American bankers were a curse to both the United States and England "by inducing the poor states to contract debts."[2]

The clergy, too, joined the campaign against the lenders as the states of Louisiana, Illinois, and Indiana went under, but by 1848 Washington's credit was repaired and the US sovereign could again borrow in London. Barings participated in the financing of the US railroads network and the Trans-Siberian railroad. Thomas Baring had become financial advisor to the czar and his bank was agent to the Russian government.

In the following years Barings continued its global expansion helping Spain and Greece to meet their interest payments. This was followed by lending to Latin America: Guatemala, Nicaragua, Columbia, Peru, and Argentina. A favored investment was mining, though some experts warned that a mine is a hole in the ground owned by a liar. Argentina received £36 million in various loans. "No warning can save a people determined to grow suddenly rich" warned Samuel Jones Lloyd, another British banker.[3] Sounds familiar?

The bad news did not fail to arrive, albeit with some delay. From 1890 to 1893 American municipalities to which Barings had lavishly lent some money went bust. In New York, tight money caused commercial and financial disasters leading to a new panic. In Berlin, negative market psychology added to the general deep recession. In Buenos Aires, the Banco National could not meet its obligations and credit collapsed. These and other incidents following on the heels of a negative market psychology increased the impact of such events and Barings was in the middle of them—but it survived for another century.

2. Elixir to Permanent "Risk-Free" Profits

According to financial history books, the 1890 Barings crisis revealed for the first time how rapidly major financial problems in one country could affect all others. Already in August 1890 Lord Lidderdale, the governor of the Bank of England, warned Barings that it was accepting too many bills from the American and Argentine agents. Three months later rumors spread through the City of London that Barings was in serious trouble.

The governor consulted other City bankers who confirmed that according to information in their possession Barings had been unable to sell its Argentine securities, and might have to stop payments quite soon. There was a weekend of make-believe calm, deliberately misleading the market. Then the chancellor of the exchequer called on the governor and they agreed that the Bank of England could not rescue Barings all by itself.

- The merchant bank's liabilities amounted to £21 million, a huge amount at that time, and
- This was more than twice the Bank of England's reserves of £10 million.

But it was appreciated at the same time that the consequences of Barings' collapse on the British economy would be incalculable.[4] Therefore, behind the scenes the governor and the chancellor organized other bankers for what became an international rescue of Barings—one of the first events of its type.

A special "Argentine Committee" was set up in London with Lord Rothschild as chairman. The chancellor and Rothschild persuaded the Banque de France to lend the Bank of England gold worth £3.5 million.

The British prime minister promised that his government would, if necessary, bear half the losses from Barings' bills. The governor also persuaded the biggest merchant banks to contribute to this special fund. Besides Rothschild, the contributors included Glyn Mills, Currie's, J.S. Morgan and, with more difficulty, the British joint-stock banks.

Eventually the consortium raised £17 million, which was instrumental in averting the crisis. Barings was reconstructed as a limited company, its top management was changed, and four years later the bank had paid all its obligations. However, the bank's reputation had been seriously damaged and, till its collapse in February 1995, Barings never again regained its old status.

The man who engineered the second Barings collapse, covered and touted by the bank's London headquarters, was Nick Leeson, the Singapore-based derivatives trader who operated in East and Southeast Asia. In her book *Total Risk: Nick Leeson and the Fall of Barings Bank* Judith H. Rawnsley talks of the ignorance and great mistakes of senior executives everywhere the institution's constellation—particularly the six inside directors and four outside directors of the parent company who chose not to see the dangers lurking in the trading arm, Barings Securities Ltd.[5]

When the board's blindness joined forces with senior management's risk on policies and exposure was reinforced by an almost total lack of internal controls, conditions were in place to drive the bank against the wall. As in so many other financial institutions that followed similar policies, the wrong incentives led straight to disaster. Moreover:

- Young traders were expected to produce disproportionately huge profits from a tiny capital base, and
- As they desperately wanted to please their bosses as well as boost their own commissions and corporate standing, traders took inordinate risks.

Few bankers indeed realize that the unstoppable drive for more profits brings along more and more exposures, some of which are unsustainable. There is no free lunch. In more than one way, a destructive behavior becomes the byproduct of uncontrollable emphasis on maximum returns. Strict controls act as a safeguard, but even those don't work when top management changes and the new policies are rotten.

A bad situation became worse when the rigorous system of internal controls Baring (and indeed all banks) should have instituted on a priority basis was nonexistent. At the end of 1994, Nick Leeson claimed to have made $30 million from his trades, nearly 20 percent of Barings' total yearly profit of $157 million. Fat bonuses followed and everybody was happy. In reality,

- Leeson had lost $285 million in 1994, carefully hidden in double books (section 4), and
- This was more than a third of the bank's total capital base, shareholders' funds, and debt capital, which stood at $800 million.

In Barings, as in other banks that lack internal controls, bogus claims on "risk-free" profits went undetected. In addition top management was not in charge of exposure (wrongly) believing that questioning its traders' methods and checking their accounts would slow down the institution's aggressive global expansion and reduce the annual bonus of not just traders but also senior managers.

In addition, the mid-1990s was a time of high stakes in finance and of big losses, too. In October 1994 General Electric lost $1.5 billion from Kidder Peabody, the broker-dealer, which, like Barings, was an old investment bank brought down by the weight of its derivatives exposure. This was compound by the loss of $800 million by GE Capital because of the toxic waste it absorbed from Kidder.

In November 1994 the Mellon Bank wrote off $130 million lost through a repurchase agreement by its Boston subsidiary. And on December 7, 1994, the Orange County Fund went bankrupt with $2.1 billion of losses because of leveraging with derivatives. In February 1995 over $1 billion was added to the river of red ink due to derivatives losses by Barings.

Nearly a decade earlier, during the Big Bang of 1986, Barings had stayed aloof from the wave of mergers that restructured the financial sector in the City. Instead of entering into a merger, it devised a system of shareholding guaranteeing that the Baring family and senior directors retained control of the bank through a split share structure.

During the late 1980s and early 1990s, one of Barings' major profit centers was the securities business, particularly focusing on Japanese shares and warrants trading business. This had become a mainstay of the bank's profits as well as losses—but both at the London headquarters and at the trading outposts, like Singapore, the bank chose to forget about the liabilities. This was fatal. It is exactly that line of business that led to the huge crisis.

3. The Responsibilities of Barings and of Regulatory Supervision

In the weekend of February 25–26, 1995, to avert bankruptcy Barings desperately searched for a rescue takeover by a big international bank.

The news that the venerable bank had reached the end of the line triggered urgent efforts by the Bank of England and the British Treasury but the invisible hand that in 1890 pulled Barings up from under did not manifest itself in 1995. That made it nearly impossible to avert a crisis of confidence in Britain's securities industry.

According to rumors, one of Barings' traders had bought more than 30,000 derivatives contracts, each priced at £120,000 (then $80,000). It was said in the City that this deal was not authorized by the bank's senior management, but such an assertion made matters worse because it demonstrated that top management was not in charge.

The Sunday Times reported that Barings had until midnight on February 26, 1995 (Greenwich Mean Time), when the Tokyo market opens, to find a buyer prepared to shoulder the derivative losses.[6] If it failed in its quest, it almost certainly had to declare bankruptcy because the losses were wiping out its reserves. *If* its positions on the Tokyo market remained open, *then*:

- Its losses would soar, and
- This would create the threat of a global financial earthquake.

Alternatively, the Bank of England had to step in and rescue the bank with public money, but the Old Lady was not ready to repeat its 1890 quest. City sources suggested that the crisis has been brewing behind the scenes for a week as margin calls were made and Barings has been unable to meet them. There was some delay till that news hit the market, and from then on there was no letup.

In a report released on July 18, 1995, the Bank of England's Board of Banking Supervision concluded that the collapse of Barings was caused by a failure of management controls as well as of other supervisory duties of the most basic kind. This report criticized senior Barings executives for failure to do their jobs properly in controlling Nick Leeson, the former derivatives trader in Singapore. The bank's policy had put on the young trader's shoulders practically all of the blame for the debacle.

The absence of a properly focused top management supervision followed by corrective action almost always involves a large number of loopholes, some of which are designed to provide traders and loans officers with freedom of action in the future. In terms of internal management controls, the Bank of England described a lax culture at Barings in which:

- Executives were uncertain of their responsibilities, and
- They did not understand the derivatives arbitrage business in the first place.

Motivated by the Barings crisis, the reserve bank came up with a number of suggestions for improving banking supervision. However, in doing so, it missed a big point. The main aim of a banking regulator should not be to prevent crazy traders from making silly bets. This is plainly the responsibility of the bank's management. The regulator's goal must be to audit banks to ensure their risk management policies, internal control, and real-time risk evaluation systems work the right way.

The problem that knocked out Barings arose not only from the complex nature of the risks being run in exotic financial instruments, but also from a broader failure of senior management duties. Equally striking was the fact that the central bank showed shortcomings in supervising Barings, as it was slow to recognize the need to cope with financial wizardry. Altogether the lessons for management are old and basic but they are rarely observed. These include the:

- Necessity of restraining star traders,
- Importance of robust control systems,
- Need to broaden the mission of internal auditors, and
- Wisdom to ensure that remuneration on merit does not encourage foolish risk-taking.

Nor surprisingly the report of the Board of Banking Supervision was very soft on the Bank of England, yet it seems that it never made an on-site inspection of Barings before the bank's collapse, despite the dramatic build-up of profits and exposures in the Far East. By contrast, the authorities at the SIMEX exchange in Singapore appeared to have been relatively alert to the dangers. No wonder therefore that the central concern of the Board of Banking Supervision's inquiry into the collapse of Barings has been how the Bank of England monitored:

- Barings' capital adequacy, and
- Large exposures in the lending and securities business lines.

The board's report stated that the Barings group produced a so-called *solo consolidated* account in which one set of capital and exposure standards were applied to both the parent and its subsidiary securities firms. Many banks use this strategy as a way to game the system of regulatory capital. (An alternative, known as *solo plus*, treats separate entities for regulatory purposes, applying capital standards to each.)

One of the board's key findings was that the Bank of England displayed a lack of rigor in its decision to introduce the supervisory system for Baring Brothers and Co (BB&Co, the parent bank) and Baring Securities

Ltd (BSL, the securities subsidiary). On the strength of these findings, the Board of Banking Supervision suggested that the central bank should go further in its role as a consolidated supervisor in order to obtain a more comprehensive understanding of:

- The nonbanking business in a group,
- How the risks in different business lines are controlled, and
- Where the significant risks may be in a financial conglomerate.

There was also a gap in regulatory duties. Not only should the Bank of England have supervised Barings, the London-based bank, but it should also have acted as the consolidated supervisor of the whole group. Analyzing group data on capital ratios and large exposures, Barings treated the securities arm as a division of the bank for supervisory purposes. In the aftermath of the bankruptcy there was talk in the City that the supervisory authorities should put up a firewall between:

- A banking conglomerate's deposit-taking, and
- Its securities business, which typically involves greater exposure.

Only then would it be possible to lend money from one part of the business to the other, *as if* it were lending to a third party. The bankers and other experts against this separation, however, argued that this solution was old-fashioned, underpinning the Glass-Steagall Act in America—characterized as being a nearly 70-year-old structure "which was crumbling." Other bankers said that firewalls were not necessary to streamlined regulation; they may even be harmful.

Those promoting very light, if any, supervision, claimed that the best approach is to let the banks develop modern dynamic solutions rather than reinventing the past. But as a myriad of examples helps in documenting, bankers, including central bankers and supervisors, who are against a more effective regulation of the banking industry are missing the point. They fail to look for danger signals in the rapidly rising "profits." This proved to be the case in Barings' Far Eastern operations, which should have prompted the right questions about risks assumed by the bank.

Another negative documented postmortem was the absence of a system for establishing whether particular subsidiaries could pose serious threats to the solvency of the banking group. As for the Bank of England, not only did it not move forward to fulfill its supervisory duties, but also quite likely it did not detect Barings management's readiness to tolerate lax controls in Singapore and other operational centers.

Last but not least, the aforementioned report by the Board of Banking Supervision questioned the effectiveness of external auditing carried out by Coopers & Lybrand (C&L) in London and by its sister firm in Singapore. C&L in Singapore had reported that internal controls at Leeson's unit were satisfactory. Yet, the Barings losses had mounted over the years but the auditors had turned a blind eye to them.

4. Star Traders and Risky Dealing

Acting as head of future trading in Barings' Singapore office in 1994 Nick Leeson earned a $1 million bonus. Much of this came from inordinate risk taking, which turned into a torrent of red ink. By February 26, 1995, Leeson had piled up $1.5 billion in losses on derivative deals that had turned sour in Tokyo and Osaka.

This is typically what happens when the wrong-way culture dominates, management and its traders are too greedy, and internal control is nonexistent or is even considered to be a nuisance. Nick Leeson's huge trading loss wiped out the venerable investment bank's capital and prompted the Bank of England to put Barings into bankruptcy. The collapse also sent shivers down the spines of bankers around the globe but whether there was a change in banks'behavior is questionable, at best.

Past the initial scare, few bankers asked themselves the all-important query: Is the greed for ever-higher profits enough of an excuse to go ahead with an inordinate amount of risk taking? From what has been revealed little by little, it seems that warning signals of a coming catastrophe did exist at Barings. The *Financial Times* obtained an internal Barings control report dated August 1994 about Leeson's extreme deals.

- The time bomb was ticking, and
- Everybody who cared to listen was invited to do so, but this did not move top management toward greater prudence.

It is nobody's secret that star performers in the derivatives markets earn good money, neither is it unknown that they also amass an enormous amount of toxic waste. Like "lucky generals," star derivatives performers make good money for themselves and the bank, employing them when there is a favorable wind. Then comes adversity, which is often self-generated and rests on the wrong guess on which way the chips will be falling.

Betting on the direction of the Nikkei 225 Index, Nick Leeson guessed wrong. He bought at 19,600 thinking the index will go up, but they went down. After the Kobe earthquake, the Nikkei 225 recovered, and, to turn his losses into profits at 18,800, he seems to have doubled his bet to a total of 20,000 derivatives contracts. That move, too, failed.

- The index did not oblige. It went down again like a stone, and
- When it hit 16,600 the red ink flowed all over Barings and it went bankrupt.

With so much money moving around so quickly, this blind betting is the kind of thing to really worry about. In 1994 in the United States alone the losses all players collected from derivatives hit $10.4 billion, and one financial shock after another became the stuff most frequently seen in the front pages of the financial press. Wild betting was promoted by the global liquidity boom of the early 1990s when more than $1.5 trillion in US mutual-funds money flooded the globe running after “profitable” deals:

- Money was available,
- Markets were ebullient, and
- Profits, when they came, were rich.

But safeguards and controls were missing. Then, by February 1994, interest rates rose and the margin of error narrowed. As Federal Reserve successively increased interest rates, the bond market’s bottom fell off. In the aftermath many banks, funds, other institutions and (most evidently) speculators paid a high price for inattention.

Whether it is an institution like Barings or a sovereign like Mexico that goes bust, the downward spiral reflects inadequate monitoring and supervision. What happened to the venerable British bank could happen to any financial institution in the world, especially if lust and greed call the tune, internal control is totally missing, and if management inertia causes the bank to fail to:

- Scrutinize high energy traders, and
- Guard against unethical salespeople.

Too many chief executive officers and chief financial officers are not even able to understand what goes on with derivatives trades. Therefore, they cannot ask critical questions about their exposure, complexity, downside, the price to be paid to hedge financial risks and whether that price is affordable.

Postmortem several financial analysts revealed that not only did Nick Leeson's trading floor his peers but also that senior management in London knew something was up but took no corrective action. The Singapore stock exchange said that they had informed the bank's top management about inordinate risks being taken a year before the cataclysm swept away Barings.

The evidence that surfaced after the debacle suggests that Barings had been taking huge positions for years in Nikkei stock-index futures. This was part of an arbitrage operation that tried to profit from minute price differences in contracts traded in Singapore and Osaka. By all evidence, top management was well aware of this fact but business continued as usual.

Less clear is whether or not senior management was involved on or around January 26, 1995, the day that Nick Leeson switched from arbitrage to speculation. He converted all the bank's contracts to "buys" quite likely in the belief that financing the aftermaths of the Kobe earthquake would stimulate the economy and push up the Nikkei.

As this hypothesis proved false, the head of futures trading compounded the initial error by selling put and call options to raise cash for margin calls, betting the market would settle into a narrow range. Then, as the Nikkei continued falling, Leeson seems to have made one last roll of the dice on February 20. Shortly thereafter heaven broke loose.

According to learned opinions the opacity of these deals was so pronounced that financial history books and academics will debate for a long time what went wrong and when exactly it went wrong. While this, like many other financial catastrophes, may have in the background a number of reasons, two are by far the most important:

- The complexity of derivatives deals that top management did not understand was one of the reasons why it gave carte blanche to a 28-year-old trader.

In fact, while semiliterate in derivatives, Leeson and other traders did not seem to have really comprehended or appreciated all of their intricacies. Selling put and call options to raise money to cover the margins of a bad off-balance sheet deal is not a responsible action because it introduces a high amount of uncontrollable risk and it creates a tandem of exposures.

- The lack of management controls and high technology that could ensure that there is a real time system of checks and balances concerning exposure, anywhere for any product at any time.

Financial analysts who followed the Barings' case suggest that Nick Leeson was permitted to clear trades because of his previous experience as a settlement clerk at Morgan Stanley. This conflict of responsibilities aggravated the fact that Barings lacked even elemental security measures. Barings allowed Nick Leeson and other people to wear too many hats. The bank's man in Singapore was both trader and manager, often setting his own targets and controls.

This conflict of responsibilities and duties is by no means a Barings specialty. It can be found all over the banking industry. As far as Barings is concerned such a violation of organizational principles was matched by a disregard of Osaka exchange rules, which stipulate that traders should be kept apart from back office employees who confirm transactions and write checks. Nobody should ever be in the front office and in the back office at the same time.

Obsolete technology compounded this problem. Even if the front office and back office are segregated in an organizational sense, controls should operate tick-by-tick at subsecond level—not 24 hours later. The bank may be unable to stop someone from going berserk, but it should have a system to catch him intraday not several days later.

Notice as well that in terms of controlling exposure, not everything depends on computers. A great deal relies on the human touch: informal, grapevine, back-channel communication links with exchanges. Also important are procedures that rest on random checks of how well the personnel follow rules and on knowledge artifacts that sound an alarm when the bank's trading volume exposure metrics are soaring. Among high technology banks specialized expert systems have become common currency, focusing on:

- Currency and interest rate risk
- Exposure due to fixed- and floating-rate debt
- Sophisticated swaps that switch among currencies and other exotics

In conclusion, the tools are available but they are not being used. Conflicts of interest (and low technology) see to it that rare is the case of banks which, at any given time, when faced with a complex position, know what is worth and the risk they are assuming. Financial history shows that in a number of occasions profit snowfalls and panics are not just self-feeding; they also promote one another as from time to time the market sentiment reverses itself. As both the Bank of England and Barings executives found out too late, the ability and willingness to ask tough questions, in good and bad times, might be the wisest policy even if it makes some people unhappy.

5. Account 88888, Double Books, and Trojan Horses

Sometime around July 1992, Account 88888 was opened in the Barings internal accounting system used in Singapore. The Board of Banking Supervision report (section 2) revealed that Leeson told Barings systems programmers to change the software to exclude account 88888 from all management and accounting reports except one. The inquiry stated: "It appears, therefore, that Leeson intended to use Account 88888 for unauthorized activity from the outset."[7]

The same inquiry suggested that Nick Leeson started using Account 88888 to hide his losses and allow himself to report higher profits. By the end of 1992, he had built up a hidden cumulative loss of £2 million (then $3.2 million). That figure seems to have remained unchanged till the end of October 1993, but losses grew more sharply after that. At the end of 1993 the cumulative loss was £23 million—while Barings Group profits before taxes for the year were £100 million ($160 million).

In early January 1995 the greatest risk that hit Account 88888 came from options Leeson had sold in the last couple of months of 1994. The trader had sold straddles that brought him a lot of fees, but lost money. According to certain estimates the 65,000 options he held in that double book account had a risk equivalent to holding £1.8 billion ($2.9 billion) of shares.

Secret accounts have been one of the main factors in bringing down a financial institution as Barings discovered to its disgrace. The bank's management came under criticism in the Board of Banking Supervision's report for other reasons as well. The inquiry listed nine "warning signs" of Nick Leeson's activities that management failed to recognize. Did senior management in London understand that the financial statements coming out of the bank's Singapore operations were fishy?

The examiners cataloged the faults of executives, which extended into almost every function of the business. As for the local Barings supervision in Singapore, it failed to deal satisfactorily with letters from SIMEX to Baring Futures pointing out irregularities in Account 88888. In London, nobody seems to have bothered when Leeson asked for increased top-up payments to fund his activities.

Nick Leeson told David Frost, the journalist who interviewed him, that business was way too fast. There was also a lack of qualified people. According to this testimony, the bank hired a young Chinese girl who had no experience. Deficient training showed up when instead of buying option contracts she sold them. There was a loss of £20,000 and the customer was informed.

According to the account he gave during the Frost interview, Leeson tried to stretch out things. That's why he (presumably) opened Account

88888 (which was a poor excuse). Five eights for the Chinese is a lucky number, bringing significant wealth (if you believe such garbage). Account 88888 also opened a Pandora's box of double accounting:

- One account for the profits, which was visible.
- Another account for the losses, which was hidden.

Incidentally, keeping double books is an age-old practice. It is in no way Leeson's discovery. It is a generalized practice.

"That money was not real," Leeson said to Frost during the interview. They had not the same effect as having a million dollars stack in front of you. If that statement is to be believed, the more than two years over which Leeson lost £350 million for Barings had no psychological effect on him. "I only got away with it," Nick Leeson explained in his interview, "because of the failure of key executives at Barings' London headquarters to understand the business we were engaged in and to look more closely into the activities." Then he added:

> The first day I asked for funding, there should have been massive alarm bells ringing. But the senior people in London that were arranging these payments did not understand the basic administration of futures and options.[8]

That interview contained no accusations of deliberate wrongdoing by any other executives of the bank. Instead, Leeson painted a sorry picture of absence of ethics, inefficiency, and greed at the top of Barings and of an almost childlike faith in his abilities by colleagues in Singapore. He was the trading hero.

Apparently Barings executives were blinded by the glory of the trading hero and by their own eagerness to book substantial profits. Nick Leeson claimed: "They wanted to believe in… the profits (that) were being reported and therefore they weren't willing to question."[9] That's the attitude taken by second-class management.

In the opinion of many analysts in London, the little bit of Barings internal control did not function properly and therefore senior management was not aware of what happened down the line. But other cognizant people contended that not every blame can be put on the bank's internal control system. Top management:

- Failed to exercise due diligence, and
- It did not bother to find out whether there was a Trojan horse in the house.

This Trojan horse was Nick Leeson's use of Account 88888, which was causing a growing hole in the balance sheet of Baring Securities. One of the hypotheses has been that, in April 1993, this hole was discovered by Tony Hawes, treasurer of the securities division, when it stood at £10 million ($16 million). No action was however taken because it was thought to be a customer account with the gap reflecting delays in claiming the cash.

A year later, however, the treasurer of Barings Securities seems to have been increasingly worried at the lack of detail given by Leeson when he made his daily claims for margin calls. That's when disorganization played a critical role. Postmortem it was stated that the worried treasurer lacked the authority to insist that a halt be put to Leeson's trading (or, alternatively, somebody "higher up" covered Leeson).

Ron Baker, head of derivatives trading at Barings before its collapse, had much more clout. Or at least this is the version published in the *Financial Times* by two of its journalists. At the time that this was published Baker was due to appear before the Securities & Futures Authority (SFA) and he was afraid it may prejudice the tribunal. Baker said: "The implication of what is said in the Financial Times is that I somehow contributed to the collapse and this is untrue… The SFA have now stated that I played no part in the collapse."[10]

Another reference made by the two journalists of the *Financial Times* was that Ian Hopkins, head of group treasury and risk management, also had concerns about the Singapore accounts. As former head of trading at Barings' merchant banking arm, he seemed to have been one of the institution's few senior executives who:

- Understood derivatives, and
- Appreciated the need for internal control.

Analysts in London suggested that Hopkins tried to persuade the bank's top management to set up a committee with the mission to investigate the institution's internal controls. But this was put on the backburner, as Leeson's operation appeared to have made a big chunk of Barings' derivatives trading profits and no senior manager wanted to challenge this flow of illusory "good news."

With no internal control in place and no will to change a make-believe "profitable" operation Barings' senior management got, in all likelihood, no wind about the loss of about £200 million ($320 million) hidden in Account 88888. Yet this represented Barings' money lost through gambling during the previous years. This was the behavior of board members and senior managers blatantly ignoring basic business and accounting principles.

6. Barings Singapore and SIMEX

Inspectors appointed by Richard Hu, the finance minister of Singapore, came to the tentative conclusion that most of the evidence of what actually transpired in the Barings scandal was to be found in Britain, not Singapore. This conclusion was reached after studying documents and interviewing more than 30 people, including former Barings chairman Peter Baring.[11]

There was, as well, an intriguing twist to the string of events that characterized the managerial, trading, and accounting scam, because of the derivatives dealings in the Japanese market out of Singapore but involving a British investment banking firm. Critics made veiled accusations that something was wrong with the SIMEX supervision.

This did not go unanswered. According to a Singapore-based account of the events, the Barings executives had assured SIMEX that the group was aware of its financial commitments in trading futures, and it would honor them. (These assurances were reportedly confirmed in writing.) In fact, up to the time of the bank's collapse Baring Futures had promptly paid all margin calls.

- In January and February 1995 alone Barings remitted over $800 million to Baring Futures for margin purposes, and
- Probably unknown to SIMEX, it was roughly what was available as capital at the London headquarters.

The venerable British bank collapsed as the losses mounted. Singapore inspectors were concerned with what Nick Leeson did with the money he had asked and received from headquarters. A larger question was how Barings' senior management allowed this situation to continue without exercising a thorough study of wheeling and dealing by the futures trader.

Published on May 25, 1995, the inspectors' report painted a less-than-sympathetic picture of Barings and those involved in monitoring the company's affairs in Singapore and London. While it was already known that Leeson's wrong bets on the Japanese stock market led to the fall of the Barings bank, the Singapore regulators were interested in learning more about the behind-the-scene moves.[12]

This was fully understandable as the international financial markets have been providing plenty of excitement not only with the Barings case but also with other derivatives trading problems that led to plenty of red ink. The Far East markets were shaken by the revelation that there were sizable positions that could not be supported, a reaction that spilled over into the European and American financial deals.

Fortune plays funny games with markets and particularly so with derivatives. Many traders in New York and London were aware of this fact, which is not true of their managements. Some of the lessons learned with Barings have been instructive. For instance, by February 6, 1995, Leeson had more or less recovered the losses incurred in the difficult days after the Kobe earthquake, but he still had a total cumulative loss of £253 million, which seems to have been some 22 percent higher than at the start of the year.

- From this date on there was a persistent downward trend in the market, and
- Against all logic, as the market began sliding Leeson greatly increased his exposure rather than retracting.

It is difficult to believe the assertion that appeared in the inquiry by the Bank of England that Barings in London thought that Leeson was taking risk-free bets by arbitrating small price differences between the Nikkei 225 contracts traded on the Osaka exchange and similar contracts traded on SIMEX. Even if top management was not specifically informed about such trades, the executive in charge of Barings Singapore operations should have been fully aware of them—but he did not act.

Transborder deals have a higher level of complexity than those made in the same exchange. Leeson's transactions involved buying in one market and simultaneously selling the same amount in the other. It transpires, said the inquiry by the Singapore regulators, that many of the positions that should have been placed in SIMEX were never concluded with other market participants. According to one hypothesis they were matched with Account 88888 positions, which should not have existed in the first place.

According to some analysts, however, this argument does not hold because it raises the important questions of when and where Leeson got the margin money that futures and options exchanges require traders to deposit to ensure they have enough funds for any open positions. SIMEX has been particularly stringent with margin requirements, hence Barings Singapore needed funds to support its ever-expanding open positions, some of which had their domicile in Account 88888 (section 4).

Besides this, as already stated, Singapore authorities appear to have told Barings in London that something was fishy. It seems that the accountants in London were themselves suspicious but they chose to put it down to poor bookkeeping and sloppy treasury management in Singapore. Using somebody else as a whipping boy is a fairly frequent practice in business.

Market psychology was negatively influenced by the revelation that, as postmortem investigations have shown, even rudimentary management control should have led to Leeson's 88888 secret account. As it transpired from the SIMEX investigation, simply by challenging "the obvious," senior management would have been able to discover that:

- There was no way to make the amount of profits Leeson reported without taking inordinate risk, some of which turned sour, and
- Allowing the same person to run the front desk and back office at the same time invalidated management control and opened the gates to fraud.

The investigations also confirmed that while Leeson did his tricks, his freedom of action was helped by the fact that at Barings derivatives trades gave him a carte blanche. This confirmation alone was enough to put the full weight of responsibility on the CEO's shoulders and on those of his immediate assistants. Yet, Barings' top management was never really held accountable for the bankruptcy of the bank.

In its way, the Barings failure demonstrated what has been and continues to be the real issue with derivative instruments. This is the quality of management globalized financial markets require, and the accountability for internal control failures. Also under this criterion the No. 1 person responsible should be the CEO.

In conclusion, the sad news is that this has not yet become a common consciousness at the commercial and investment bank level even today—two decades after the collapse of Barings. At the level of the board of directors the skills necessary for appraisal and reappraisal of the way the firm operates were scarce. In addition, there has been no evidence that anybody took the initiative to bring personal accountability to the foreground.

7. Barings' Acquisition by ING

After Barings suffered $1.4 billion in derivative trading losses, on March 6, 1995, Barings' banking, securities, and asset management operations were bought by the Dutch financial conglomerate Internationale Nederlanden Groep (ING). The Dutch financial conglomerate (which encountered its own severe problems in 2008) was particularly keen to get control of Barings' emerging market research and equities businesses as well as its fund management arm, because it had itself, for some years, been focusing on emerging market debt trading.

It is interesting to notice that ING did not buy Barings' holding company, which had to be liquidated. This was not an omission, but a significant difference in assumed risk. While with its purchase of Barings divisions the Dutch firm became responsible for Barings' existing liabilities, any future claims were to be borne by the holding company. Financial analysts believed that there may be plenty of such claims, as Barings senior management had:

- Failed to tighten lax risk controls in futures operation in spite of repeated warnings of the dangers these posed.

Much was learned, for example, from evidence released by Singapore's regulators that pointed to a lax supervision within Barings. Part of the evidence was a memo written in 1992 by James Fox, head of Baring Securities in Singapore, to Andrew Fraser, Barings' head of equities, that expressed doubts about organizational issues, including the likelihood that the structure being set up would subsequently prove disastrous.

Another evidence worth bringing in perspective was an internal audit that warned of the dangers of allowing Nick Leeson to control both trading and settlements. But inertia at top management level had put these audits and warning letters in the time closet with the direct result that it:

- Allowed vast amounts of money to be transferred from London to Singapore shortly before the bank collapsed.

In January and February 1995 Barings headquarters transferred a total of £569 million to its Futures operations in Singapore. Under European Union rules, the bank should not have put more than a quarter of its equity capital (which at the time was only some £325 million) in any one investment without Bank of England approval.

There were good reasons why in London the Serious Fraud Office entered the investigation, but its job was a hard one since Nick Leeson's trading records for January and February 1995 had disappeared. Still an official inquiry into the regulators' role in the Barings affair wanted to know why this apparent breach of the rules went unnoticed.

There has been no evidence that ING and its executives were knowledgeable of the intricacies of derivatives trades that came along with the Barings purchase, but at least some analysts thought that by studying published statistics and the gaps these presented they knew something more about them than did Barings' top managers who had totally failed to understand the basics of the futures markets. Even if they were aware that Leeson was not arbitraging at all, but taking a one-way bet on the Japanese market, they lacked the knowhow to put a lid on the deals—and on the bank's exposure.

ING simply took its chances with the Barings purchase and maybe it accepted another hypothesis making the rounds in the financial industry that Barings headquarters thought they were in effect transferring money on behalf of clients. This was too dumb a failure to be believable, yet some people think that it could be one of the plausible cases.

It has never been known how that supposition worked itself into the mainstream of financial information. It probably happened when the Barings crisis broke open, as some senior Barings managers might have claimed that they were paying margin on behalf of serious clients. There was talk that the Japanese operation of the bank's futures business did not require one potential client to deposit initial margin with it. This, too, was a violation of the rules.

- Both OSE[13] and SIMEX ban their members from paying margin for their clients, and
- If it had breached this rule, Barings could well be sued, or banned, by regulators in Osaka and Singapore.

The silver lining of the Barings crisis has been that it led to an information-sharing agreement between the clearing arms of 19 American securities and futures exchanges. Such an initiative was designed to serve as an early warning system in the event of a potential large default but, as the 2008 financial industry meltdown demonstrated, this, too, did not work so well.

Members of the United Clearing Groups, as the aforementioned US initiative was called, were optimistic that similar information-sharing arrangements would eventually be possible across borders by expanding the concept internationally: Singapore's SIMEX and the Osaka Futures exchange, which were directly involved in the Barings trades, established a similar agreement.

Things were somewhat different in London, particularly for the city fathers who watch over its square mile financial district. Barings fell to ING in March 1995. A couple of months later, in May 1995, S. G. Warburg agreed to become a subsidiary of the Swiss Bank Corporation after Morgan Stanley dumped it at the altar. Then Kleinwort-Benson gave up its independence after its merger with Dresdner Bank.

Some analysts said that Britain's proud merchant banks fell into the clutches of better capitalized continental European rivals and therefore London looked like a big loser. Others, however, pointed out that London's role was growing, not shrinking. As continental Europe rivals established themselves in London, the British capital became the preeminent center of Europe's financial services industry.

Continental banks were pouring billions into London to tap the pool of talent they needed to compete as global investment banks. Their hope was that the combination of British expertise and the newcomers' deep pockets would eventually put London in a position to challenge New York's global role. In addition Europe's investment banks were consolidating to take advantage of an increasingly open market. Effective on January 1, 1996, a European Union directive allowed EU investment houses to trade freely across borders, no matter what country they were domiciled in.

The timing was right and this was not only because of globalization. In the US, the Glass-Steagall Act prohibiting commercial and investment banking under the same roof was breaking down, making it easier to take business away from the big New York investment banks. The dice was cast for more financial gambling and for less supervision. The Casino Society was getting ready to have a ball. In 2007 and 2008 we saw its aftermath with the global economic and banking crisis.

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10

Parmalat: The Hedge Fund with Dairy Products on the Side

1. Parmalat Scandal Hit Small Investors Hard

Theoretically, Parmalat was a fast-rising dairy products company accepted as being one of the stars of the so-called Italian economic miracle. Practically, more than anything else, its business was speculation and financial gambling, that ended up as a major scandal while those responsible escaped prosecution as usual.

In the aftermath of the Parmalat and several other scandals that preceded and followed it, there has been a popular resentment against banks and business in general. This was accompanied by a crisis of confidence as hundreds of thousands of Italian families lost their savings that they thought had been safely invested according to the advice they had received from their banker and advisers over the years.

As in all other cases when it erupted, this crisis of confidence had dramatic aftereffects. Like the Japanese, Italian families have historically been at the top of world saving rates. With Parmalat, that was money down the drain. In the aftermath, Italian credit institutions were targeted by public opinion, the judiciary, and even parliament, because they were considered responsible not for one but for a tandem of failures in their fiduciary duties.

For example, in the 1980s, through their purchases of treasury bonds family savings bailed out Italy's government in connection with its huge public debt. But in the 1990s, as Italy joined the Maastricht treaty and implemented convergence policies to join Euroland, falling state bond yields moved Italian families to invest their savings in the then booming stock market, and most particularly in the financial industry, the fast-rising industrial firms (like Parmalat), and the privatization of public companies. An estimated €225 billion ($300 billion) in privatization of Italy's public sector attracted family savings into the Milan stock exchange whose capitalization grew by leaps and bounds:

- From 11 percent of GDP in 1992,
- To 70 percent of GDP in 2000.

Then, in 2001, the stock market collapsed and Italian families lost billions. To make matters worse, Italian banks subsequently offered a *safe* investment in state bonds, convincing their customers to buy Argentinian debt because so many Italians live in that country. When in 2002 Argentina declared bankruptcy, about 450,000 Italian small investors lost €12 billion. Another 40,000 lost €1.2 billion in the insolvency of the Cirio food company. Thereafter came the Parmalat bankruptcy that pulverized the savings of 100,000 small savers.

In the 1980s and 1990s equities and bond investments were relatively new in Italy where the large majority was accustomed to the use of savings accounts. Few among the small savers knew that they were putting their money at relatively high risk. Pensioners particularly trusted their bank. This radically changed after savers found that in some cases banks sold Parmalat bonds to their retail customers on the very day the company officially defaulted.

In Rome, the regional department of the Financial Police delivered a thick report to prosecutors, establishing that in the Cirio and Parmalat cases the responsibility for dumping insolvent bonds on retail customers lay at the level of the central directors of the banks involved in that scam though these transactions were executed in the branch offices. There was no way whatsoever to accept that the banks did not know about the bankruptcies associated with the securities they were selling (even if this excuse was among several that were heard). Still, practically nobody was prosecuted.

Companies at the edge of the precipice are masters in the use of deceit. To give a false impression of financial staying power to investors, credit rating agencies, and regulators, Parmalat had an American listing for some of its securities. The spotlight cast on this firm's overall fraud, as well as on others that preceded it in 2000–2002 with similar gimmicks, documented how vulnerable the financial system is when:

- Creative accounting calls the tune,
- A maze of offshores is ingeniously employed to hide the facts, and
- Safeguards are perverted, either deliberately or through incompetence.

"It fooled a lot of people that Parmalat was able to maintain a New York listing for its American Depository Receipts (ADRs)," said Christopher Seidenfaden of Unicredit Banca Mobiliare.[1] Investors were reassured that Parmalat was satisfying American regulatory requirements. In a letter to *The Economist*, François Veverka, a Paris-based executive managing director of Standard & Poor's, stated that Parmalat and its advisers repeatedly provided the rating agency with detailed information about its:

- Assets,
- Liabilities, and
- Liquidity position.

Indeed, they did so in response to the rating agency's inquiries till December 5, 2003. Such information typically confirmed the audited accounts but double bookkeeping and its BBB credit rating were enough to warrant care in dealing with the firm, was enough to warrant low investment grade rating. Subsequently it has been found that like the audited accounts themselves, the information Parmalat gave to S&P was utterly misleading.[2]

Still investors were fooled into placing their nest egg in a house of cards. The point Veverka essentially made is that until it missed its bond repayment on December 8, 2003, there was no indication in Parmalat accounts that the company faced an imminent liquidity crisis. This is a frequent happening when creative accounting holds the upper hand.

Human nature being what it is, all the talk about strengthening auditing standards is no more than of theoretical interest. Neither are more onerous standards on the securities exchanges a sort of magical solution—though, admittedly, this is necessary. The answer is prosecuting wrongdoers more swiftly, and upping significant penalties. That's precisely what did not happen.

Creative accounting by the companies that went bust played a key role in the scandal. Critical information was simply suppressed. Parmalat's financial accounts for 2002 had failed to disclose that €496 million (then $622 million) of its cash had been invested in Epicurum, a mutual fund based in the Cayman Islands. In a way reminiscent of how bankers play derivatives-and-securitization games with other bankers, besides that "investment," Parmalat had also entered into a huge currency swap with Epicurum.

The Parmalat-Epicurum deals are a classic on the hecatomb that can be opened by overleveraging and the expanding use of derivative financial instruments for reasons of deception. Yet banks said to their clients that Parmalat was considered to be a well-managed firm with relatively low credit risk. The parent company's curious relation with Epicurum was disclosed postmortem in November 2003, after Consob, Italy's stock market regulator, practically asked for information about it.

With the market getting wind that things were not as pristine as they were thought to be, Parmalat tried to quell market fears by saying, on November 12, 2003, that it would withdraw its money from Epicurum within 15 days. This, of course, did not take place because, as it happens so often with leveraged and uncertain deals, when rumors (let alone news) of financial instability break out, every busybody tries to exit from the same door.

Parmalat's case is one more proof of the fact that credit risk and market risk reinforce one another, and their synergy ensures that events are moving way beyond management control. Mindful of Parmalat's withdrawal of €496 million, other "investors" in Epicurum feared for their own funds and triggered a rush of withdrawals. It needs no explaining that in the aftermath:

- Parmalat was unable to get its money out, and
- When it asked its banks for short-term help, it was rebuffed.

On December 8, 2003, when the banks' negative answer became known, trading in Parmalat shares was suspended and the company's board reluctantly convened the next day. Enrico Bondi's appointment (section 6), initially as a consultant, faced headwinds because Calisto Tanzi, Parmalat's chairman and CEO—who had led the company first to glory then to scam—would not relinquish his CEO job. Still Bondi's appointment was the price of the banks' limited support till heaven broke loose.

2. Leveraging and the Disappearance of Public Funds

Italian banks were not the only financial institutions to benefit from, and eventually pay for, this cozy and highly ineffective relation to Parmalat and its top brass. Global banks, including Citigroup, JP Morgan, and Deutsche Bank, were willing and ready to earn lucrative fees by constructing derivatives deals by which Parmalat:

- Transferred funds offshore, and
- Speculated with them.[3]

In a way quite similar to that of Ahold (the Dutch food company), Vivendi Universal (the French conglomerate), as well as the now-defunct US high flyers, Enron and WorldCom, Parmalat's financial problems were ignored for too long by its bankers, auditors, and supervisors. All of them had shown an inordinate laxity. Maybe they were taken in by the wrongdoers' constant self-promotion and they did not have the brains to challenge the "obvious." There were also conflicts of interest.

Credit rating agencies, too, had some explaining to do but as usual they found refuge behind a statement that it was tricky for outsiders to monitor what had been going on behind closed doors. Like Enron, Parmalat failed to disclose lots of information to Standard & Poor's, but this being the case the agency should not have issued investment grade ratings on its bonds. Instead, it should have brought this lack of disclosure to public attention.

As the drama of the Parmalat scandal unfolded, responsibility centered to a small group of people who have shown total lack of management accountability. Calisto Tanzi was both chairman and chief executive officer of the group. The investigation by prosecutors revealed a close complicity between him and Fausto Tonna, the company's chief financial officer. In their way Tanzi and Tonna echoed the roles of:

- Ken Ley, Jeff Skilling, and Andrew Fastow at Enron,
- Bernard Ebbers and Scott Sullivan at WorldCom, and
- Dennis Kozlowksi and Mark Swartz at Tyco.

The investigation also found evidence of employees who either knew or suspected what was going on, but kept it secret. The founder, chairman, and CEO of Parmalat admitted to magistrates that he cooked the books for more than a decade, skimming off at least $640 million from his publicly traded dairy company. For his part, Parmalat's chief financial officer provided hours of testimony to prosecutors detailing how he and Tanzi pulled off the biggest fraud in European financial history. Tonna told prosecutors that:

- He benefited personally from funds held by subsidiaries in Luxembourg, and
- The company took kickbacks from the Swedish packaging group Tetra-Pak, which the latter denied.

As answer to why Parmalat was boosting debt further and further when it supposedly had huge cash reserves (as it said it had), CFO Tonna had a standard reply: The company was on an acquisition spree and needed cash. In addition in 2003 the liquid funds were earning good returns, 3.5 percent after taxes, and cash was channeled to these investments.

The early part of 2003 was the time when equity analysts were becoming increasingly skeptical. A colorful aspect of this story is that some negative comments by analysts as well as mounting criticism led Tanzi to counterattack. On March 20, 2003, he sent a 34-page complaint to Consob, the Italian stock market regulator, charging Lehman Brothers and others with seeking to slander the company in order to make speculative gains on Parmalat's shares.

For his part Calisto Tanzi was a star performer in manipulating bankers, investors, auditors, and regulators. Most of his arguments were smoke and mirrors but the bankers bought them, though some suggested that as a manager he was already out of his depth. In the 1970s Tanzi had made acquisitions in Brazil and in Europe that proved to be largely unprofitable. To cover his company's shortcomings:

- He focused on growth at any cost, and
- He reportedly paid little attention to profit and loss performance.

Politics, too, played a key role, as they nearly always do. In 1988, after an acquisition spree, Tanzi faced a debt crisis, but friendly politicians helped him arrange an $80 million financial bailout from a seven-bank consortium led by Monte dei Paschi di Siena (the oldest and third-largest Italian bank that had confronted its own scandals of a certain magnitude).

After this, Tanzi learned his lesson and he began creating a web of financial companies in the Dutch Antilles, which the Italian magistrates believed were used to hide liabilities from investors. Much was done prior to listing Parmalat's shares on the Milan stock exchange. Another web was that of patronage by big global banks, which eventually had very serious implications. Did the international bankers know about the scams? Did they deliberately ignore the warning signs?

- If they did not know, they were incapable as bankers.
- If they did, their case is even worse, because they had become willing accomplices.

In either case, the global influence of well-known banks helped in spreading the mayhem among investors from London to Alaska. Some $1.5 billion in Parmalat bonds were sold to US investors alone, mainly through private placements. It is absolutely ridiculous that bankers, accountants, legal advisers, even some members of Calisto Tanzi's family, all claim that they had no idea of what was going on.

"What's appalling is that the mistakes were made by many banks all over the world. Parmalat was a totally international affair," said Valter Lazzari, professor of banking and finance at Bocconi University, Milan.[4] As *BusinessWeek* aptly commented, the Parmalat megascandal and Tanzi family saga is a story of globalization gone wrong. The evidence that emerged indicated that many investment bankers in Italy and Germany:

- Harbored doubts about the dairy products company's numbers for years, and
- They were suspicious of its superheated growth, wondering why an Italian dairy company needed to raise so much debt if it had billions in cash.

Yet, in spite of their doubts the big banks continued dealing with Parmalat, and, according to rumors, some of them seemed to have liked what they saw. After all, Parmalat was a hedge fund with dairy products on the side, a global fast-growing company with books audited by one of the Big Four—all good reasons to court that company for its steady business, particularly its stock and bond offerings.[5] This speaks volumes about ethics in these banks, as well as about the quality of corporate governance.

While, a decade after the crash of Parmalat much remains unknown, what is known is unsettling. Substantial assets have disappeared from the dairy company just like hundreds of millions of dollars were siphoned off from Enron, WorldCom, and the other ex-star performers who went bankrupt. In fact, in the Italian company's case Calisto Tanzi admitted he diverted (read misappropriated) funds from the group. According to the former CEO, this took place to the tune of hundreds of millions of euros over seven or eight years.

In connection with Parmalat Finanzaria, SpA, Tanzi told magistrates he moved €500 million ($675 million) from the company's treasury to tourism business outfits owned by his family. The money was shifted into a series of firms that had to be subsequently analyzed one by one to verify the cash flows, Fabio Belloni—one of Tanzi's lawyers—informed and provided evidence to reporters outside Milan's San Vittore jail, where Parmalat's former boss was held after his arrest on December 27, 2003.[6]

For its part, on December 29, 2003, the US Securities and Exchange Commission sued Parmalat with fraud for filing misleading financial statements during 2002 and 2003. The suit in a New York court alleged that Parmalat had engaged in one of the largest and most brazen corporate financial frauds in history. An Italian judge said Grant Thornton, one of Parmalat's auditors, had advised the group to set up a Cayman Islands subsidiary to modify the system used till then to hide losses. If this is true, Arthur Andersen could not have done better.

Guido Piffer, the Milan judge, accused Tanzi of having "perfect knowledge of the fraudulent mechanisms" that were used to inflate Parmalat's assets and conceal billions of euros in liabilities. This accusation, which did not amount to a formal criminal charge, was contained in a seven-page ruling drafted by Judge Piffer to justify the decision, on December 28, 2003, to continue holding Parmalat's former chief executive under lock and key.

In his ruling, Judge Piffer also alleged that Tanzi had "instigated and endorsed" the financial schemes that led to the discovery of a big black hole in Parmalat's accounts. "It could not have been otherwise, taking into consideration the enormity of the financial breakdown that had to be concealed, and considering that Tanzi himself, and people in his family, were the beneficiaries," the ruling stated.[7]

3. The Banks of Parmalat

At the center of the Parmalat scandal lies a letter, reportedly from Bank of America, in which the credit institution is said to have confirmed that Bonlat, a Parmalat subsidiary based in the Cayman Islands, had deposits of close to € 4 billion (then $5.5 billion) with the bank. Grant Thornton, the auditor of Bonlat, seems to have relied on this Bank of America letter for evidence of the Parmalat subsidiary's assets until, in mid-December 2003, Bank of America said that:

- The document had been forged, and
- The cash simply did not exist.

Without that money, Parmalat's empire came crashing down. Besides this particular issue, which remained in the dark in connection to its origin, and the reasons it took so long to call it a scam, many investors were reassured by the repeated willingness of big international banks to underwrite new bond issues for Parmalat. Citigroup, Bank of America, Deutsche Bank are among the institutions that underwrote Parmalat bonds. They were not alone in that business. The banks that worked for Parmalat are listed in Table 10.1.

Table 10.1 The Banks of Parmalat

Italian Banks €4 Billion
- Banca di Roma (Capitalia)
- Banca Nazionale del Lavoro
- Cassa di Risparmio, Parma
- Credito Emiliano
- Ex-Banca Popolare di Bergamo
- Intesa
- Monte dei Paschi
- San Paolo
- UniCredit

Foreign Banks
- ABN Amro
- Bank of America
- Bank of Boston
- Barclays
- Citigroup (Epicurum, Buconero)
- Deutsche Bank
- JPMorgan Chase
- Merrill Lynch
- Morgan Stanley
- Nomura International
- Santander
- UBS

Critics say that while Parmalat, the parent company, was offsetting high levels of debt on its balance sheet through presumably forged documents, big banks, which should have known better, were ready to oblige. The deceit was all over, from headquarters to subsidiaries (see also section 4). False financial reports showed "assets" held at its subsidiary level, such as Bonlat, and these matched the head office's statement about riches beyond belief.

Critics have pointed out that the auditors were not careful in their line of work and this was also true of users of the "audited" books, including banks. They accepted the audits without any questioning. For their part, investors took the audited group figures as reassurance that, although complex, Parmalat's finances were essentially sound.

"What is the one line in an audited balance sheet that no one questions?" asked a former auditor with Deloite & Touche. "Answer: the cash and other short-term assets line. And that is precisely where this fraud was directed."[8] By all evidence, behind the fake €4 billion cash balance at Bank of America. Parmalat had engineered a sophisticated swindles scheme. It was not sufficient for Bonlat and other group subsidiaries to merely claim fictitious cash balances.

- They also had to generate a paper trail of false sales, and
- That trail had shown to the auditors where the money supposedly came from.

This has been a premeditated and well-orchestrated deceit that ran over a number of years. The love affair of Parmalat with international bankers did not develop overnight. As a sharp operator, once Parmalat had gone public, Calisto Tanzi quickly began tapping into the vast global capital markets. Between 1990 and 2003, the Italian hedge fund with a dairy products line on the side raised a total of about $8 billion in debt, globally.

Between 1997 and 2002, Bank of America arranged $743 million in debt sales. Chase Manhattan, Bank of Boston, Deutsche Bank, Barclays, and Merrill Lynch sold billions of dollars of debt. The cash injections fueled fast growth at Parmalat's side, with 17 acquisitions in 1993 alone:

- This boosted revenues from $800 million in 1990 to $9.7 billion in 2003, and
- It led to more and more loans by willing commercial banks, while investment banks obliged by underwriting and selling Parmalat's bonds.

Even after some of the scam's details started to become known, there was little doubt that even if business was tough Tanzi found banks willing to do business with his hedge fund. In addition to underwriting Parmalat's last bond issue in September 2003, which paid interest of 6.125 percent at the time of offer, Deutsche Bank purchased 5 percent of Parmalat's shares on the same date, but sold most of his position (to 1.6 percent) on December 19, 2003, shortly before the crash. Investors who bought the equity based on the bank analysts' positive comments, got burned.

To say the least, the involvement of money center banks with Parmalat looked sloppy. Deutsche was a leading borrower and lender of Parmalat shares and seems to have had other relationships with Parmalat. Massimo Armanini, the German credit institution's top investment banker in Italy, worked for the company from 1998 to 2000. Moreover, as reported in the press, in late November 2003, Deutsche's ratings advisory team helped Parmalat draft a presentation to Standard & Poor's to answer concerns about suspected liquidity problems. This took place about a month prior to Parmalat's bankruptcy.

The aftereffect of this collaboration by international bankers was that it enabled the Parmalat top brass to capture the corporate debt market.

Even if some people raised questions about a dairy products firm's policy of going for more and more debt despite its seeming mountain of cash, this did not affect the banks' patronage.

Business ethics had taken a leave and so did management efficiency. Such a strange asset allocation should have been an alarm signal. It was also curious that some banks issued reassuring research reports until a few months before Parmalat's collapse. An October 2003 equity report by Deutsche Bank:

- Rated Parmalat's shares a buy, and
- Noted the strong cash flow, which warranted higher premium.

In November 2003 Citibank also issued an optimistic bulletin on the company, shortly before Parmalat failed to meet a $184 million payment to bondholders. Under prodding from Deloitte, it also admitted that it could not liquidate some $640 million it had said it held in Epicurum, the murky Cayman Islands mutual fund whose activities Calisto Tanzi and company could not exactly describe.

At the same time, however, while the big banks continued patronizing Parmalat some private equity firms seem to have sensed impending disaster though they still showed interest in the Italian hedge fund. In a last-minute maneuver on December 9, 2003, Tanzi and his son Stefano met in Italy with executives of the Blackstone Group, about a possible buyout. The meeting came a day after Parmalat admitted that it had not recovered the aforementioned $640 million payment from the Epicurum investment fund in the Cayman Islands. Wisely enough, Blackstone did not bite.

Instead, not unexpectedly, lawsuits started to fly in America where the company had sold more than $1.5 billion worth of bonds to US investors and investment funds, including several big life insurance companies. That was a curious investment choice and it demonstrated that institutional investors are not really careful in their placements. They fail to be informed about specifics—for instance, Italian rules and laws that were broken by Parmalat and its auditors—and therefore turned a blind eye to the fraud. They only took note of the fact that through financing by foreign investors and takeovers, Parmalat:

- Had become an international business player, and
- Was clever at exploiting the differences in legislations and regulations that exist between jurisdictions.

But the day of truth eventually came. Filed on January 5, 2004, on behalf of Parmalat investors, a US-based class action targeted Citigroup, Deloitte Touche Tohmatsu, and Grant Thornton International, in addition to Parmalat management. The charges ranged from assisting in manipulative financial transactions to participating in the falsification of audit confirmation documents.

Milberg Weiss Bershad Hynbes & Lerach,launched a class-action lawsuit in New York on behalf of Parmalat investors. The Deutsche Bank and other big financial institutions were not specifically named in the suit, but Darren Robbins, a spokesman for the law firm, said that Deutsche Bank is "in it up to the eyeballs."[9] In mid-January 2004, Italian magistrates raided the Milan offices of Deutsche Bank, seizing documents.

Officials at the Italian offices of Bank of America and Citigroup were also being questioned, as were the top executives of Italy's largest banks. Prosecutors suspected that many agents from banks, law firms, and accounting companies were involved in the fraud, making it more difficult to detect its mechanics. Two outside accountants for Grant Thornton, the auditor, were under arrest. Twenty-five other outsiders were under investigation, including two Deloitte managers and a former Bank of America corporate banker in Italy.

Moreover, Italian magistrates were asked by the government-appointed administrator of Parmalat to investigate whether international banks had charged excessive fees to the dairy products firm for loans of €1.85 billion (then $2.3 billion) organized since July 2001. Proving that bank fees for complex and high-risk financial operations were excessive is a difficult job. The investigators asked for information and clarification from five banks: Nomura International, UBS, Morgan Stanley, Deutsche Bank, and UniCredito Italiano.

This inquiry, which was a major element of the search for at least €12 billion missing at the Italian dairy group, was a round of sparring between Enrico Bondi, the administrator, and numerous banks that financed the bankrupt group. Under Italian bankruptcy law, Bondi could revoke deals Parmalat struck up to 24 months before it filed for bankruptcy on December 24, 2003, if those transactions could be seen as unfavorable to the bankrupt company. The law allows a company that has gone under to revoke agreements and puts the onus on the counterparty to justify the terms of the transaction.

4. The Name of the Game Is Deceit

According to some estimates, as of February 1, 2004, a month after the bankruptcy of Parmalat, at least €14 billion ($19 billion) disappeared in the overall scandal. It is simply not possible that so much money turns into ashes, runs into pockets, or whatever, without the collaboration of major financial operators. The name of their game was deceit.

When in mid-December 2003, Parmalat announced the replacement of its chief executive officer, it also made public the appointment of two banks to oversee its restructuring: Lazard Brothers and Mediobanca. Since the end of World War II Mediobanca was the larger of the two longer-term Italian lenders allegedly closely allied with the big insurance company Assicurazioni Generali. Other major shareholders have been Capitalia (the former Banca di Roma linked to the Sindona scandal of the mid-1970s), Monte dei Paschi, Banca Intesa, BCI, UniCredit (the former Credito Italiano), Banca Nazionale di Lavoro, Cassa di Risparmio di Parma, Credito Emiliano, and many more—some of which were also Parmalat's Italian financiers.

As Table 10.1 has shown, among foreign big banks Citigroup was one of the major American lenders to Parmalat and its advisor and partner in some deals. Other foreign banks that benefited from the Parmalat relationship were Bank of America and JPMorgan Chase from the US, Deutsche Bank from Germany, Banco Santander from Spain, and ABN-Amro from Holland. A whole constellation of well-known credit institutions lent to Parmalat, underwrote its bonds, traded with it in derivatives, and contributed to the deceit.

In the period before its huge financial hecatomb came to light, Parmalat had become involved in highly toxic collateralized debt obligations (CDOs) to the extent of over $1 billion. This was one of the most rapidly expanding sectors of the global derivatives markets, lucrative as well as speculative and very risky. The company's speculative ride was not a smooth one even prior to the CDOs adventure.

Ironically, the high stakes started after having stumbled in its more classical line of business. When it was still a milk and dairy products company, before becoming a hedge fund, Parmalat first came close to bankruptcy in the late 1980s. It is said that DeMita, the then secretary general of Christian Democracy, the mammoth political party that ran Italy for nearly 50 years after World War II, arranged a syndicated loan and this let Parmalat off the hook.

By all evidence this eleventh-hour salvage also taught a lesson to Calisto Tanzi, the company's founder, chairman, and CEO. He learned through practical experience how easy it was to call the bankers' fire brigade to the rescue when you know somebody near the pinnacle of political power. This lesson on how to organize a high-handed deceit left an impression in the mind of Parmalat's CEO and it is said to be at the origin of two strategic moves.

- The company's international business expansion left, right, and center, and
- Its conversion into a covert overleveraged hedge fund (section 5), with no attention whatsoever paid to risk management.

The strategy directed the company's attention to where the money was to be found.[10] Parmalat's American adventures started in 1997, when the company decided to intensify its campaign of international acquisitions, especially in North and South America. All of these mergers and acquisitions were financed through debt and in the process Parmalat became the third largest cookie-maker in the United States.

Management's lack of business ethics and ineffectiveness matched the company's Mount Everest of leveraging. These were largely disconnected acquisitions that did not bring the "expected" profits; instead the firm confronted a torrent of red ink. By continuing to lose money on its original business activities, Parmalat shifted more and more to the make-believe world of derivatives and other speculations that also produced red figures—the latter being marked by more and more debt.

Huge sums were poured into different unrelated enterprises, like a tour and soccer club in Parma, which added to the losses from the very beginning. Parmatour was closed down after accumulating an estimated loss of at least €2 billion ($2.7 billion), too high for a tourist outfit. The exact losses of the Parma soccer club are not fully known. As for the derivatives gambles, they simply accumulated debts covered through loans and the sale of equity and bonds.

The way out was cooking the books and this was matched by a maze of offshore mail-box companies. A network of shell firms was used to conceal the red ink by making the different positions appear as assets or liquidity, piling up deceit upon deceit. Using that network Parmalat issued bonds in a big way, bonds whose fake security was provided by the alleged liquidity represented by the offshore schemes.

The banks of Parmalat obliged. The way it has been reported postmortem, the largest bond placers allegedly were Bank of America, Citicorp, JP Morgan, and Deutsche Bank, helped by Italian partners in the financial industry. The worst part of the story is that these worthless bonds were rated as sound financial paper, while the banks underwriting and selling them knew, or should have known, that they were worth nothing. This, too, was part of the organized deceit.

One of the scams that surfaced postmortem related to the New York–based law firm, Zini. Allegedly through it, companies owned by Parmalat were sold to American citizens with Italian surnames in a deal including the clause that these empty shells or outfits swimming in red ink would be purchased again, later on, by Parmalat.[11]

- The purpose of such fake transaction was to create liquidity in the books, and
- Based on deceit this liquidity permitted Parmalat to continue issuing bonds.

In his interrogation by Italian magistrates Calisto Tanzi allegedly declared that the fraudulent bonds system was fully the banks' idea. Moreover, Fausto Tonna, Parmalat's former chief financial officer, allegedly cooked Parmalat's balance sheets in order to attract buyers for the bonds—but it was the banks that proposed it to Tonna, Tanzi declared to prosecutors.

According to experts, Tanzi's depositions have been confirmed by Luciano Spilingardi, head of Cassa di Risparmio di Parma and member of Parmalat's board. Bond issues were ordered by the banks, Spilingardi said to prosecutors, according to leaks published in Rome's daily newspaper *La Repubblica*. I remember, Spilingardi said, that one of the last issues, of 150 million Euros, was presented to the board meeting to subscribe the entire bond…it was Deutsche Bank (which suggested it).

In his deposition, Spilingardi added that he had expressed perplexity about the proposal, because, in the spring of 2003, a previous bond issue of €600 million ($810 million) had failed, causing a 10 percent fall of Parmalat stocks in one day. But the request was finally accepted, and money from the last Parmalat bond, issued in the summer of 2003, made its way to the Cayman Islands—another deceit for investors.

An apparently curious case was Parmalat's purchase of the Cirio Food Company, a defunct firm. The rationale behind it was to return a political favor. In the Cirio case, on the eve of its insolvency, creditor banks rushed to dump their Cirio bonds, by selling them to their customers. That practice was repeated with Parmalat bonds.

Italian newspapers published letters of Parmalat bondholders describing how they had still been sold such bonds by their banks on December 11, 2003, two days after the first Parmalat default, and after Standard & Poor's had downgraded them to junk status. Small savers got burned as banks repeated over and over again the same wrong policy with their retail customers.

On February 25, 2004, nearly two months after Parmalat's bankruptcy, Italy's judicial system was embroiled in a fresh controversy that involved a local bank as well as the Bank of Italy. This came after a prosecutor placed Antonio Fazio, governor of the central bank, under investigation in an inquiry into a possible fraud at "Bank 121," the former Banca del Salento.

The governor of the Bank of Italy was one of 38 people caught up in the inquiry launched by the prosecutor's office in Trani, Puglia region, into financial products sold by Banca 121 to ordinary Italian investors—an estimated 100,000 of them. No formal accusations were leveled at Fazio, with the inquiry seeking to establish whether he abetted suspected fraud in the sale of Banca 121's financial products that, according to certain opinions, were designed to beef up its profitability prior to its acquisition by Monte dei Paschi di Siena.

The Banca 121 affair involved the sale in 1999 and 2000 of financial products whose names sounded similar enough to Italian government bonds to lure some people into thinking they were buying rock-solid investments. In a sovereign state with trillions of euros of public debt, government bonds are not "rock-solid" by any stretch of imagination. But small, unsophisticated investors did not appreciate the difference. Still the products sold by Banca 121 were even higher-risk instruments and the value of some fell by as much as 70 percent.

It is worth noting that the role of the Bank of Italy as a financial markets supervisor and banking regulator was unchallengeable in the 1960s and 1970s. In this century, however, it has come under close scrutiny with the unfolding of a series of scandals such as the sale of Parmalat, Cirio, and other debt of failing outfits as well as the sale of Argentine government bonds to retail investors in the Italian market. In each case, thousands of savers have been left with large losses as their nest egg was smashed in an orgy of deceit.

5. Parmalat as a Hedge Fund

There have been reasons to believe that the collapse of Parmalat's bubble may not be just a WorldCom- or Enron-style debacle, but a larger version of a financial crisis, of the crash that characterized the failure of Long-Term Capital Management (LTCM) hedge fund. As it will be remembered, in September 1998, the bankruptcy of the Rolls Royce of hedge funds not only shook the foundations of the world monetary and financial system but also demonstrated that something was wrong with the modern version of high finance.

That crisis of 1998 had put the New York Federal Reserve in the frontline in trying to solve the deep-rooted financial problem before it spread globally. With Parmalat, the leading evidence was that what had happened was akin to a resurfacing of the LTCM crisis—albeit of Italian dimensions but less well controlled than the September 1998 crisis. At the eye of the storm were the banks of the Italian hedge fund with a dairy products line on the side (Table 10.1).

In terms of financial plotting and executing dirty deals, there were similitudes between Parmalat and Enron, the hedge fund with a gas pipeline on the side. These similitudes ranged from cooking the books to playing in a big way in the derivatives market, and engineering lots of scams. The absence of business ethics and the prevalence of inefficiency in the Enron and Parmalat cases were separated by a mere two years.

From the day the Enron scandal broke publicly in December 2001 the major financial press, including the *Wall Street Journal*, focused their attention upon the Enron-controlled network of thousands of subsidiaries, affiliates, ventures, and entities most of which were deeply involved in Ponzi games. The press also singled out a handful of Enron executives and bankers who built up, manipulated, and sustained that network.

The bankruptcy of Parmalat, warned Italian finance minister Giulio Tremonti on December 22, 2003, runs the risk of leading to *general corporate insolvency* in Italy, if there is a wider run on corporate bonds. Not only in Italy but throughout Europe, financial entities and industrial companies with loans contracted in the capital market were getting increasingly nervous about:

- The enormous sums of debt instruments that went up in smoke, and
- The unknowns associated with how far and where the trail of criminal investigation would lead.

The Italian government was aware of the systemic dimensions of the crisis generated by the fall of the country's largest hedge fund, at least in what concerned the Italian bond market. "Do you have any idea," said Termonti to his colleagues, "of what would happen if the market demanded liquidation of money invested in corporate bonds? Therefore, we must quickly review current legislation protecting investors."[12]

This preoccupation has been no different from the one in the United States in September 2008 with the earthquake at AIG, Fannie Mae, and Freddie Mac that threatened to set off a chain reaction followed by a collapse in the value of the subprime and Alt-A mortgages used to prop up the bubble.[13] Tremonti also referred to 100,000 Italian owners of Parmalat bonds, mostly families that were advised by their bankers to buy the defunct company's paper when the scam was still under covers. By the end of December 2003 these bonds were worth nothing.

Another challenge confronting the Italian government at the end of December 2003 was that the case of Parmalat was not the first but the third large insolvency hitting Italian investors in a couple of years. Critics said that, not unlike their international colleagues, Italian bankers had lured unsuspecting customers into high-risk investments. Pensioners, workers, and professionals did not understand the moving sands *where* their money was invested. All they knew was what they were told by the banks that it was safe.

Many retail investors became aware of the financial precipice only after the collapse of Parmalat's hedge fund, which threw the spotlight on the colossal volume of non-transparent financial deals. Many of them dirty, they were run by both doubtful operators and big international banks through offshore centers like the Cayman Islands.

- Theoretically, such deals are often used to finance illegal, political, speculative, high-risk efforts.
- Practically, the Parmalat scandal exposed this questionable structure of the global financial system.

In the beginning, investigators found it difficult to believe that a dairy products firm acted as a hedge fund with a long list of secretive deals and hundreds of empty shells as subsidiaries. Only when the evidence piled up did they appreciate that what looked like the largest food company in Italy, and the fourth largest in Europe, controlling 50 percent of the Italian market in milk and milk-derivative products, was in reality an unstable structure waiting for the bubble to burst.

Aside from the damage done to retail investors, the nation's economy also suffered. The cost of Parmalat's bankruptcy represented 1.5 percent of Italy's gross national product (GNP). This was proportionally larger than the combined ratio of the Enron and WorldCom bankruptcies in the US compared to America's GNP. In January 2004 Giulio Tremonti said the Parmalat affair would cost the state about €21 billion. That offset the sacrifices the government made in 2003 to cut the budget deficit, but the indirect effects on the Italian economy were even bigger.

Acting as a hedge fund with a dairy products line at its backend, and giant financial speculation in the background, Parmalat was able to lure investors and siphon off their savings through a network of 260 international offshore speculative entities—where the money eventually disappeared. It has been reported that among these entities at the receiving end of the scam, the Cayman Islands–based offshore Bonlat had "invested" $6.9 billion in interest rate swaps, which are risky derivative financial instruments, and it had lost lots of money.

One of the half-dramatic and half-hilarious revelations about the Parmalat scandal was that Italy's feared financial police was confronted with a claim by Tonna, Parmalat's CFO, that his boss could fix the dates of supposedly random tax inspections. It did not happen that way, but while the examiners of the financial police started working, the common citizen discovered the high price attached to a major scandal.

In the first week of February 2004, the prosecutors probing Parmalat came under a cloud when Giovanni Panebianco, the leader of one investigation, resigned after being charged with corruption.[14] Critics stated that the political old chaps' network was also hard at work, with a business culture rooted in ties of blood and friendship, just like in its heydays. Parmalat was employing uninquisitive public accountants and very cooperative bankers held together by a web of reciprocal favors revolving around companies characterized by:

- Lack of ethics,
- Inefficient governance,
- Opaque reporting,
- Weak regulation, and
- Tolerance of corruption.

On February 14, 2004, Michele Ributti, the chief lawyer for Calisto Tanzi, resigned after he was placed under investigation for allegedly laundering Tanzi's cash. Ributti was suspected by Swiss and Italian investigative magistrates of having laundered €1 million[15] (which was peanuts compared to the huge amount of funds that disappeared in the Parmalat affair). Vittorio D'Aiello, the lawyer's lawyer (Ributti's lawyer), rejected the allegation that his client laundered money, saying:

- The money was paid by Tanzi for "professional services" into a bank account belonging to Ributti, and
- The cash never left that account, therefore it cannot be considered money laundering (a curious statement at best).

Such allegations and counter-allegations were a sideshow to the global probe into the disappearance of €14 billion from Parmalat's accounts, but they highlighted the Italian magistrates' effort to tie together as many suspicious transactions as possible before pressing charges against Tanzi, many other former Parmalat executives, and bankers for the hedge fund-and-dairy group.

6. The Restructuring Effort Befalling the Administrator

On February 25, 2004, Enrico Bondi, Parmalat's administrator appointed by the government, secured that Banamex, a subsidiary of Citigroup, would unfreeze bank accounts held by Parmalat's Mexican subsidiary. This decision allowed the subsidiary to resume payments to suppliers and showed how Bondi has been trying to keep some control on Parmalat's sprawling assets in order to produce a viable rescue plan.

The government-appointed administrator initiated a series of legal actions, one of them against the Brazilian authorities to regain control over Parmalat's operations in that country. In mid-February 2004 the parent firm had lost control over Parmalat Brasilas when a Sao Paolo court appointed a team of administrators headed by Keyler Carvalho Rocha, a former central bank director, to manage the subsidiary.

In Italy, Parmalat's administrator was also fighting moves by some creditor banks that could reduce his authority over company units outside the Italian jurisdiction. In February 2004 he got a subsidiary placed under Italian jurisdiction, ahead of an attempt by UBS to put it under a Dutch court's authority. Also, Bank of America, a major Parmalat lender, has sought Eurofood's liquidation in Ireland. A court in Parma decided Eurofood should fall under Italian juridical authority.

In another dispute, Bondi wanted a court in the Cayman Islands to remove Ernst & Young as an appointed liquidator for the Parmalat units registered there. That appointment was made in December 2003 at the request of six US creditors, all of them life assurance companies. Losing judicial control over some financial units would have made it much harder for magistrates to access documents.

In late March 2004, about three months after being entrusted at the eleventh hour with the rescue and administration of Parmalat, Enrico Bondi revealed his plans for saving the dairy products company (but not its hedge fund activities) from the financial scandal engulfing it. What he suggested made sense:

- Swapping €14.8 billion ($19.7 billion) of debt for shares, and
- Streamlining the company's operations by selling minor businesses.

By March 2004, however, the Parmalat scandal had acquired a much wider dimension than what it appeared to be at end of December 2003 when the downfall occurred. In Milan prosecutors searched the local offices of big foreign banks looking for evidence connected to murky credit derivative deals and other information related to a Parmalat bond issue in the summer of 2003 and what they found documented once more the absence of business ethics.

In July 2003, some five months prior to its crash, Parmalat issued bonds worth €420 million. But the hedge fund with the dairy product line on the side got only €130 million, as it was forced to buy bonds worth €290 million issued by Banca Totta, an institution controlled by Banco Santander. The Totta bonds in Parmalat's portfolio were linked to a credit default swap.

In the case of Parmalat's default, those Totta bonds were worth zero,[16] but the bank that organized the issue of those debt instruments remained a creditor of Parmalat to the tune of €420 million and not of €130 million. This was another reason why Parmalat's hedge fund wheeling and dealing greatly resembled LTCM, the hedge fund that, as has already been discussed, crashed in September 1998.

When at the end of March 2004, Enrico Bondi presented Parmalat's financial results, these amounted to liabilities of €14.8 billion ($19.7 billion), of which €4.2 billion were bank loans; the overall picture was that of high inefficiency on all sides of that deal. Bondi's proposal to the creditors was an accord through which, after a hefty write-down, loans would be converted into equity in the company. In the background was the hypothesis that the company might recover after heavy cuts in operations:

- Reducing its debt by about €500 million (if at all possible),
- Reducing geographic coverage from 30 countries to 20, with commensurate personnel reductions,
- Cutting the number of its labels from 120 to 30,
- Redimensioning its annual revenue from €5.8 billion to €3.8 billion, and
- Doubling its operational margin from 3 percent to 6 percent, with 10 percent a further-out goal,

If it did recover, and that was a big IF, *then* it could start sailing again in the world of dairy products. The years that passed by, however, tell a different story. As an administrator Bondi was quite efficient, but the problems he confronted were enormous because Parmalat was so deeply damaged. The ancient Greeks had a word for Calisto Tanzi's behavior: hubris. To this was added lack of ethics and plain malfeasance.

The best epigram for Parmalat's tombstone came from an Italian banker who said: To last for the better part of 15 years, it must be that many gardens and pockets have been watered. This type of breaking news scandals don't happen accidentally. They are the result of nourishment by a lot of actors, whose cover-ups work till the bubble becomes way too big and finally blows.

* * *

It will never become really known how far the supervisory authorities were involved in the Parmalat scam. Sometimes people responsible for supervising and policing get themselves too close to the wrongdoers or try to benefit from the situation. Here is a real-life example. On January 7, 2014, in New York, 106 persons, including 80 retired police officers and firefighters, have been indicted by grand jury for disability fraud.

Ethics had taken a leave of absence. Among the 106, 4 were accused of masterminding that fraud in exchange for generous kickbacks. Allegedly they directed scores of law enforcement retirees to lie about their health to obtain benefits to which they were not entitled. Prosecutors said that the defendants received more than $21 million in benefits—peanuts compared to the Parmalat billions but a big sum nevertheless.

The defendants who allegedly participated in this deceit had claimed that in the aftermath of hardship in performing their duties they could no longer work or lead active lives. But on Facebook, Twitter, and YouTube investigators found pictures of them playing basketball, using jet skis, and flying helicopters. One of the accused who claimed to be virtually housebound was snapped fishing for marlin in Costa Rica.

In the opinion of Cyrus Vance, Manhattan's district attorney, the scheme that dates back to 1988, may have involved as many as 1,000 people and as much as $400 million in benefits[17]—another evidence of our society's lack of ethics. According to statistics published by *The Economist*, the number of Americans receiving disability payments has shot up from 4.9 million in 1999 to 8.9 million in 2013—an 830 percent increase in a mere 14 years. Fraud is rife in nearly all countries and in all walks of life. Combined with borrowed money, the absence of orderly and ethical behavior can produce a dangerous crisis to a person, a family, a company, and a nation as a whole. Italy, for example, used to be a prosperous nation in the 1960s and 1970s.[18] Look at it now.

11

Ethics and Efficiency in Manufacturing and Services

1. Kodak's Lesson

In the 1980s Eastman Kodak, then one of the two global leaders in the photography industry, made a study on corporate survival, taking two kinds of companies as samples: One included companies that had prospered for decades in a competitive business environment and the other included firms that had lost their market and disappeared. A quarter century later, in the early 2010s, Kodak itself fell on its sword while Fujifilm, its archrival, prospered.

What the Kodak study of the 1980s demonstrated was that the difference between being at the corporate death's door and sailing through successfully is made by management—precisely, the level of management efficiency a company has attained. But this quality has to be sustained if not steadily improved. Five years of mismanagement, the Kodak study demonstrated, are enough to knock out a company.

Founded in 1880 Kodak was known for its innovative technology, efficient marketing, and well-focused cost control. In the mid-1970s it accounted for 90 percent of film and 85 percent of camera sales in America, and until the 1990s it was rated as one of the world's five most valuable brands. Then it lost speed and the market skipped away from the venerable firm:

- Product and market evolution ceased being its management's focus, and
- The company fell behind other industries' product and market policies, which progressively ate up Kodak's turf.

By 2011, Eastman Kodak had become a perfect example of what in the 1980s it had criticized as being a poorly managed, inefficient firm. Originally it was not behind the drive for innovation, as evidenced by the fact that (in 1975) it built one of the first digital cameras. But it did not follow up with the new generation of pictures either. Hence it got deeply hurt when digital technology was followed by the development of smartphones that double as cameras.

By the middle of the first decade of this century, digital photography replaced film while smartphones took a toll on cameras. The high-water mark of Kodak's revenues (nearly $16 billion) was in 1996 and the peak of its profits (at $2.5 billion) was in 1999. In 2011 its revenues dropped to about $6 billion and the company reported losses in most quarters of its activities.

An inefficient management chased the past rather than looking at the future. This increased Kodak's woes. Suing Apple and HTC over alleged patent infringements did not help. The same was true of Kodak's desire to keep cheap Japanese film off its patch, to the point that preparation for Chapter 11 bankruptcy became most urgent.

True enough, both Eastman Kodak and Fujifilm saw their traditional business line becoming obsolete. But while Kodak failed to adapt adequately, Fujifilm has been able to transform itself into a solid, profitable business, with a market capitalization of some $12.6 billion compared to Kodak's $220 million. To confront the rapidly changing technology and market landscape, Fujifilm developed a strategy based on three pillars:

- Gaining as much money as possible out of the film business, while the old product lines were still in demand,
- Preparing for a switch to digital technology the big way ahead of its competitors, and
- Developing new business lines projected to open new horizons in profit making in the global market.

The opening of new business lines was crucial as Fujifilm and Kodak realized that by itself digital photography would not be very profitable. Both firms had to adapt to the changing market, but Kodak was slower because it remained a complacent monopoly looking inward rather than embracing an expanding market.

Complacency meant that Eastman Kodak executives suffered from a mentality of "perfect products" in the firm's traditional line of business, which they saw as long-term winners, while Fujifilm executives used them as temporary cash cows. Working in a one-company town did not help, either. Kodak's bosses in Rochester seldom heard much criticism of the firm, even if there were plenty of issues to talk about.

The absence of criticism strengthened the feeling of an elusive superiority increasing the feeling of complacency at the top executive level. Even when management decided to diversify, it took years to proceed with its first acquisition. Neither did it make enough bets with R&D projects aimed to create breakthroughs. By contrast, Fujifilm diversified quite successfully and by so doing it enlarged its market leadership.

By seeking Chapter 11 bankruptcy protection, Kodak documented another finding of its study. Failures are likely to hit those companies harder that have been in long-term decline, where the combination of tougher competition and a lackluster switch in product orientation (like photography) was too little too late in making a successful market change. There are entire sectors in business and industry that face cyclical challenges, for example, the natural gas and coal product lines.

Management's inefficiency at Eastman Kodak had little to do with the market being afraid to fund a fallen angel, if the leadership did not appreciate the firm's problems and made matters worse than they might have been otherwise. Throughout 2012, investors had funded companies at higher risk of default than Kodak. "The high-yield bond market doesn't operate in isolation: [it] lives and dies on good credit analysis," said David Ying of Evercore Partners. "While we are living in a world where benchmark rates are phenomenally low, both companies and investors have to realize these are unusual times."[1]

Investor confidence, however, wanes if the business is not growing and the company is leveraged. It is becoming increasingly possible that investors would not come forward till they can sense first class management, serious restructuring, and efficiency in operations. Even before a company goes ahead and files for Chapter 11 protection, it pays to know:

- How to manage creditors, and
- When and how it will be in position to propose refinancing solutions.

It is also important to know how it handles assumed global liabilities to avoid protracted court action. Along this line of reasoning, in Britain, the Kodak Pension Plan (KPP) came up with an alternative scheme for existing members to avoid former employees from falling into Britain's pension protection fund after Kodak's parent company, Eastman Kodak, entered bankruptcy protection in 2012.

This initiative was not just an issue of avoiding legal costs and public relations fallouts. Contrary to the lawsuit against Apple, from which the company hoped to get an income, a court battle over pensions might have been simply a deadweight on a dwindling budget. It would have also distracted from the effort of turning the bankrupt Kodak into a powerhouse of digital printing, which became its new business strategy when, in late 2013, it exited Chapter 11.

In management's opinion general economic developments were rather positive for a new departure on a global scale. One of the factors influencing this projection was that with globalization the social costs in developing countries have increased. In year 2000 US wages were almost 22 times higher than China's, but according to some economists by 2015 that multiple would have declined to nearly 4.[2]

One of the results of this ongoing change in wages and salaries has been that outsourcing, the far cry of the late twentieth century, is getting outmoded. In 2013 Jeff Immelt, General Electric's CEO, declared outsourcing as mostly being outdated as a business model. GE's Appliance Park in Louisville, Kentucky, opened new assembly lines to build refrigerators, water heaters, and washing machines, bringing home jobs from China and Mexico—a move that several commentators greeted as a US manufacturing renaissance. Depending on its level of efficiency a reborn Kodak could benefit from it.

2. BlackBerry Puts Itself Up for Sale

Eastman Kodak was a prosperous enterprise that fell on hard times because top management was not bold enough to confront well ahead product and market challenges, steering the company toward new opportunities. Similar reasons prevailed at BlackBerry, which reacted slowly with reduced focus to changes in the telecom market. As a result, in less than four years, BlackBerry's:

- Control of a nearly 20 percent share of the global smartphone market shrank to less than 3 percent, and
- The firm's share price lost 90 percent from the peak of almost $80.

After a change in management did not have the projected result of turning the company around, BlackBerry put itself up for sale hoping that a white knight could help the ailing Canadian handset maker in its battle for survival. By mid-August 2013, however, analysts said that in the highly competitive smartphone market the life of BlackBerry in its original form had come to an end.

The Canadian smartphone maker did not have the long successful history of Kodak as the dominant player in its industry (most particularly in the American market), but its product's technical features ensured that it was well received. The first BlackBerry device was sold in 1999, its competitive advantage being secure email and other messaging applications, which appealed to business.

The similitude with Kodak was that complacency took the driver's seat, forgetting all about a longer-term strategy. Delays did not help. By the time the company's new BlackBerry 10 handset was launched, it lacked clear technological advantages when compared to the wider choice of smartphones already on the market. The "Nokia mistake" was repeated once again. No wonder then that sales were disappointing. BlackBerry was slow in coming forward with:

- Innovative features, and
- Deep cost cutting.

In the aftermath competitors like Apple and Samsung created such a formidable lead that it proved impossible to overtake them. In addition, as one misfortune never comes alone, the company's bankers warned that the value of Blackberry's assets had dropped to a dangerous point, given the firm's dwindling subscriber base, with a worrying cash burn in its accounts.

By mid-August 2013, with share price sinking, the firm's equity was valued at just $5.3 billion, a long and deep drop from the $41 billion high-water mark when the company, then called Research In Motion, was considered to be Canada's technological flagship. Technical problems compounded the fall.

BlackBerry's private operating system (OS), which had been an advantage in the past turned into a liability. For 2014 Google's Android OS was expected to conquer 42 percent of the market, Microsoft's Windows 15 percent, Apple's IOS/MacOS 14 percent, leaving a mere 29 percent for all other players—none of them having a two-digit market share. One of these "other players" was BlackBerry, projected to have a mere 1 percent to 2 percent of the total smartphone market—an unmitigated disaster for its already negative operating margin.

Events proved analysts right when they warned that BlackBerry faced an uncertain future if BB10 failed to recapture its loyalists and win back the customers the company has lost. The alternative was to become a niche player in a market driven by scale, an unsustainable strategy even in the short run.

The alternative of becoming a takeover target was not on the table then. Potential buyers like Samsung, Microsoft, and Nokia ruled themselves out, while Lenovo, a likely buyer, was afraid that the US government would block an acquisition due to national security concerns. Solutions become so much more complex when, for whatever reason, governments show up as arbiters.

There was speculation about a potential buyout backed by private equity. But even if a vulture fund was to come forward, the difficulties BlackBerry faced as a public company were unlikely to be resolved by simply moving to private ownership. There was, as well, the added need for extensive investments to succeed in the fiercely competitive telecoms market already dominated by big companies.

While the problems confronted by BlackBerry were quite different from those faced by Intel, some commentators expressed the opinion that certain similitudes saw to it that the case of the former should be seen by the latter as a worst-case scenario for its own sake. What one can learn from Eastman Kodak's fate adds to this lesson. When the product structure moves outside the mainstream because the market radically changes, it is highly dangerous to take too much for granted even if the profit margin continues being appreciable.

- Reinventing the company and its products is the only way to save it from a severe downturn, and
- Reinventing calls for a strategy of creative destruction that requires the existence of risk takers at the helm.

Along this reference to similitudes, BlackBerry's and Intel's internal challenges could be expressed through two issues that correlate in several ways. In Intel's case, as 2012 came to a close, Paul Otellini, the CEO, announced that in a few months he would step down from the top job at Intel, leaving no clear successor for the first time in the company's history. That was not the world's biggest chipmaker's only internal challenge. The other challenge was to gain leadership in the fast-growing markets for smartphones and tablets.

Though Intel maintained its domination of the PC world, with the company's processors "inside" four out of every five personal computers being manufactured, the PC market has been shrinking while portable devices take the foreground. In this transition other chipmakers made significant inroads in the new mobile markets—a case reminiscent of BlackBerry's loss of its client base.

Theoretically the Intel engine was running on all cylinders, doing what it always did best: pushing the limits of silicon technology to produce ever-smaller transistors and fine-tuning a manufacturing base to give the company a lead of over 12 months compared to challengers. But practically the company did not find a way to lead in developing new markets.

CEO Otellini made some gambles to give Intel a stake in the future, but the results did not match the original hopes and expectations. This has been bad news for Intel, particularly as the formerly vibrant global upgrade market cooled. IBM confronted the same problem. Many clients in mature markets no longer see the need to upgrade. Companies confronted by this challenge must find a way out of their legacy bind before they hit a dead-end.

3. Has Hewlett-Packard Made a False Step?

Since the middle of 2010, the record of Hewlett-Packard (HP) has been less impressive than that of other information technology companies like IBM and Accenture, which have seen (in 2010–2012, but not in 2013) an increase in service-related sales. With headwinds confronting the personal computers business, HP—which in 2010 had $126 billion annual revenue and 325,000 employees—needed to decide whether it should continue to compete in so many areas as it was accustomed to do, and whether it should focus on software and services. In the latter case it had to make sacrifices elsewhere in its product line.

Abandoning cash cows because their future was not bright was an agonizing decision that landed on the shoulders of HP's new CEO, Leo Apotheker, a former boss of Germany's SAP software firm. Apotheker's plan was to spin off Hewlett-Packard's personal computers and its $40 billion annual revenue. Underlining its new direction, HP agreed to pay $10.3 billion for Autonomy, a British software company. Investors responded negatively to this shift in strategy.

Since the market did not like the switch, it punished the company's equity and HP lost a quarter of its value within a week after it announced its new strategic plan. As the negative reaction continued, the company's stock fell to the lowest price-to-earnings ratio of any big technology firm. Some analysts suggested that HP could become a takeover target.

To make matters worse, prospects of a buyer for the PC unit were dim. Bankers said that the most likely course would be to spin it off to HP shareholders. Apotheker was trying to convince them that this would give them holdings in two viable companies:

- A fast-growing enterprise software firm, and
- A steady business unit focusing on PC hardware.

Analysts challenged the hypothesis behind the second bullet pointing out that consumers have been migrating toward using mobile devices, with combined sales of smartphones and tablets expected to outstrip PC sales. By majority, however, investors were as unclear as HP's top management about what was to be done with the PC unit and why Apotheker intended to pay so much for Autonomy. The overwhelming market opinion was that the company's new CEO was taking a huge gamble by trying to follow IBM's example by:

- Reducing HP's dependence on hardware, and
- Getting into software and services where margins are at least theoretically higher.

Critics said that Leo Apotheker's strategy was an investor and public relations failure. Some added that even if it was vindicated later on, which was unlikely, HP was entering a time of turbulence. It had needlessly alienated investors by thrusting so much future uncertainty on them at once. This carried lessons for other chief executives who sought to make a big impact within a short time of their arrival to the vertex of the firm.

Just trying to put straight what a new CEO has inherited feels like a routine task, yet it is an important one allowing him to establish his authority and to set a clear strategy before he can expect others to follow the new direction. Several technologists suggested that the reason HP paid a high premium (64 percent) for Autonomy's shares is that its business orientation could be turned into a platform to help companies make sense of *big data*. Under that term fall two fast-growing classes of business information:

- Structured data like payroll records and sales figures, and
- Unstructured documents, such as emails, which now make up more than 80 percent of the information that flows through a typical database.

In the opinion of other experts, Autonomy's acquisition could help HP to increase its revenues by selling software outside its current main market with emphasis on an entry into the turf of IBM. The pros maintained that adding document management software to its existing storage systems would allow Hewlett-Packard to explore new markets like healthcare processing.

The counterargument has been that to reach its goal of having software generate 10 percent of its revenue, up from less than 3 percent when these events took place, HP will probably have to make further acquisitions, distracting from its current services business which is mainly about keeping IT systems leadership. This do-what-IBM-did principle is, moreover, no business penicillin because the market eventually gets saturated by software vendors and consultancies. (Indeed in 2013 of the 30 equities making up the Dow Jones, 29 advanced. The laggard was IBM.)

Another unsettling element connected to Autonomy's acquisition was that even before HP announced it in August 2011, there were rumors that the British software company's growth was due partly to fuzzy accounting. Information questioning some of Autonomy's rapid growth was widely circulated around the time of its acquisition, making Apotheker the target of further criticism.

Mike Lynch, Autonomy's founder and CEO, denied any such irregularities, saying that they were "completely and utterly wrong and we reject them completely."[3] The pros pointed out that when Hewlett-Packard bought it, Autonomy was Britain's biggest software company, and the second-largest in Europe after Germany's SAP. Its customers included intelligence agencies, big corporations, banks, and law firms.

Allegations about creative accounting irregularities raised fresh questions about the British auditing industry, which many investors have long suspected of being too close to company managers. At about the same time, serious concerns about the quality of other accounting practices emerged as a result of its role in the Libor rigging scandal (chapter 7), and the role Barclays Bank played in it. In the end, there was no proof of irregularities in Autonomy's operations, but the damage was done.

At Wall Street and the City of London the opinions of market makers and market players were divided as to whether Hewlett-Packard's breakup was a wise move. At least one broker-trader, Merrill Lynch of Bank of America, was a contrarian to this happening. In an investment report it stated: "Despite press speculation again around HP breaking-up/spinning out certain business(s), we continue to believe that the break-up of meaningful size and impact is unlikely…The recent speculation regarding HP's potential sale of certain businesses is greatly exaggerated and highly unlikely. We view any breakout along customer segment (i.e. consumer and corporate) as unlikely, given synergies in PCs and printing between the two customer segments. HP remains a turnaround story with challenges in most of its businesses."[4]

For his experience as a former boss of Germany's SAP, Apotheker probably knew that acquisitions often do not work. Yet he bet a big chunk of HP shareholder money while also closing the hardware division of Palm, a British company that his predecessor bought for $1.2 billion a year earlier. Barely had Palm's TouchPad tablet been launched than it was ditched.

Other soft spots at Hewlett-Packard have been software and consulting. In August 2012 it announced that it was taking an $8.8 billion write-down related to the division dominated by the former EDS advisory services group, which it had bought for $13 billion in 2008. Meg Whitman, the new chief executive who replaced Apotheker, has been attempting to restructure the group after a turbulent two years in which HP has forced out two chief executives.

People familiar with HP's strategy in connection with Autonomy's acquisitions suggested that Whitman was looking for a way to unwind the deal before it closed, but could not find any material accounting issues. HP's new CEO stated her company had relied on Deloitte's audit of Autonomy and had hired KPMG for any additional review, but added that neither firm found any irregularities. The $8.8 billion write-down however remained and the fall in Hewlett Packard's equity price continued.

At Wall Street, some analysts expressed the opinion that the cheapened HP shares looked tempting. The trouble was a supposedly low price/earnings ratio of around four times relied too heavily on earnings figures ignoring various restructuring, acquisition, and impairment charges. The mammoth $8.8 billion charge was a blow to investor confidence.

To regain the investors' attention and their confidence, Hewlett-Packard slimmed down by cutting 27,000 jobs across its business operations. It also restructured and streamlined its divisions, doing what it could to remove the stigma of a company that has a sorry record of overpaying for acquisitions and then, shortly afterward, writing off most of the value.

The EDS write-down triggered a revaluation of HP's other assets. Before it ended this accounting restructuring took $20 billion of goodwill and intangibles off HP's assets in one single year: 2012. To appreciate what lay behind this strategy one must remember that Silicon Valley companies have always lived or died by growth and profit margins. Venture capitalists fund software and Internet companies on the promise of:

- Rapid growth, and
- High margins.

When growth slows they have an identity crisis. The counterpart is that it becomes relatively simple to inflate the value of software companies by way of accounting, using technological prowess as the justification. With software one presses a button and records a sale at very low or almost zero cost.

In its way Hewlett-Packard documented all that is great about Silicon Valley, at least in the company's first six decades. It was a start-up that was founded in a garage and grew into a high-tech powerhouse thanks to relentless innovation and solid management. But from 1999 things started to go wrong. The company got and lost several chief executives in a short span of six years. Carly Fiorina was dumped in 2005 after HP's share price halved; Mark Hurd in 2010, after what was considered to be a sex scandal; and HP's board sacked Leo Apotheker after the Autonomy acquisition and just 11 months in office.

Analysts and managers debated what went wrong with HP. Was it just the passage of time and the computer industry's maturity? Or was it that HP fell victim to the policy of reaching outside its ranks to hire a star as CEO. The latter is something that never seems to work. If anything, the opposite is true. The more dazzling the outside recruit, the worse is his on-the-job performance.

4. Carmakers and Their Overcapacity

The blues of the global car industry crisis deepen as more manufacturing capacity is added while factories work well below their production potential. Nowhere is this more evident than in Europe where politics and nationalism influence the future of the car industry even if two of the old continent's automakers are among the top five in the world.

Worldwide car production and sales in 2013 indicated that, when its production is combined with that of its affiliates Daihatsu and Subaru, Toyota is not far from becoming the first member of the 10 million club. Next in line are GM and Volkswagen each with over 9 million autos per year, followed by Renault-Nissan-AutoVAZ with 7 million and Hyundai-Kia with nearly 7 million. Ford has fallen to sixth position with not quite 6 million and the recently merged Fiat-Chrysler is in the seventh position with a little over 4 million autos. With one exception, forget the other contenders.

The exceptions are the makers of luxury models with well-known and appreciated brands, like BMW, Daimler, and Jaguar Land Rover. They do well selling relatively small volumes of cars for good profits. By contrast, life is getting tougher for a squeezed middle of auto makers who are selling mainly mass-market models at margins. These auto makers face a tough job to make a profit and their survival is far from being assured.

The best example of that breed is PSA Peugeot Citroën. In October 2012, following its bailout by the French government, Peugeot entered into a cost-cutting alliance with General Motors which was short-lived (more on this later), followed by another alliance with Dongfeng, the Chinese car maker. "Alliances" hammered out by auto manufacturers are complicated, full of conflicts of interest, and they come unstuck when benefits to either or both sides become unclear.

The alliance of GM and Fiat did not work while that of Suzuki and VW fell out even before they got started on a planned small car for emerging markets (that matter went to arbitration). Experts suggest that, the way the chips are falling, the bigger carmakers are likely to survive in the long term while the stragglers fall by the wayside or radically redimension their operations:

- Cutting overheads with a sharp knife, and
- Closing factories in a way that allows them to carry on even with a smaller part of the market.

Ford followed that strategy when it announced the closure of a Belgian car plant. This factory employed 4,300 people. Its production will move to Spain. Ford also convened a meeting with British labor unions, sparking fears that it was going to close its Southampton plant, which employs about 500 workers. Ford however appreciates that having plants working at greatly reduced capacity is pure suicide.

With unemployment statistics running high, decision about plant closures bring heated reaction from politicians and unions. Peugeot and GM have been two auto manufacturers who suffered the most in the slowdown, hence their decision to collaborate on four vehicle platforms, ranging from small cars to people-carriers, in a move projected to save them, by 2016, $1 billion each in synergies was not without reason. It was surprising that a year later (in 2013) they called off their plans to cooperate.

Critics said that not just a vague conflict of interest but nationalism and protectionism played a key role as Peugeot finalized a €7 billion ($8.9 billion) government-made bailout for its Banque PSA Finance holding, which has been the French government's biggest intervention in the industry since 2009.[5] (At the same time Peugeot was criticized by France's government for its plans to close its Alnay plant and cut more than 6,000 jobs.)

Bar protectionism, it is hard to understand the GM-Peugeot split even if it has been generally attributed to a collaboration Peugeot worked to establish with a Chinese car maker and a fight over who will take what of the Iranian car market *if* and *when* the sanctions are lifted. This collaboration seems to have started on the right foot when at meetings held in Paris, Detroit, and Rüsselsheim (headquarters of GM's European Opel operations), a ten-member steering committee, split between executives from the French and US carmakers, worked on details of what platforms and eventually what cars they would make together.

Insiders said that in the GM-Peugeot case there were as well corporate culture clashes and some political controversies, but these were to be expected. There have been, too, angry responses from labor unions worried about future vehicles being taken off from their lines, which endangered jobs and plants. But the two firms upheld a target for synergies they expected to extract from their alliance and they also understood that they had to improve the bottom line of either and both firms in the alliance.

In spite of positive factors, however, within the car industry there were rumors that the Franco-US talks on joint developments were going badly when the two companies addressed problems of manufacturing overcapacity in their plants. Such meetings were more productive when they had focused on the line-up of upper-midsize cars: Opel Insignia, Citroën C5, Peugeot 508, which sold about 200,000 units combined, a low number in a scale-driven industry.

With production and sales levels that low it was evident that they needed to work together closely in order to reduce costs. The overcapacity problem, however, was acute as, according to some estimates, Peugeot and GM were using 59 percent of their capacity in 2012 and neither company was willing to accept closing nearly half of its plants.

Yet, the fact was that both GM and Peugeot were losing their share of the European auto market and talk about keeping the plants running through an alliance were not too different from talks on how to avoid gravity: Car sales in the European Union stood at slightly over 13 million in 2012, down from 16 million in 2008 (a high-water mark). Worse yet, car sales in the EU were on track to fall by about 7 percent in 2013 while auto manufacturing factories in the EU had an installed capacity to build a little more than 19 millions autos per year.

Much of this extra capacity was however old and inefficient, contributing a great deal to each company's costs. Peugeot's plight was a contrast to Volkswagen's fortunes. Not only has the German automaker been in full expansion of its manufacturing and marketing facilities, but it has also developed and maintained a solid financial position that provided a big funding advantage—allowing the carmaker to compete fiercely on leasing and financing rates.

It is not surprising that the impact of financial staying power has been supreme, magnified by the fact that six out of every ten car factories in the EU are losing money. This was instrumental in sparking a race to the bottom on margins. Brands desperate to shift vehicles cut prices and beef up incentives to unsustainable levels. As for car plant utilization in 2013 it stood at:

- 46 percent in Italy
- 62 percent in France

- 67 percent in Spain
- 70 percent in Poland
- 79 percent in the Czech Republic
- 81 percent in Germany
- 86 percent in England

As these statistics demonstrate, in continental Europe, only in Germany is plant capacity above 80 percent, because of the profitable Volkswagen, BMW, and Mercedes lines. The fact that many of VW's volume competitors blamed German resistance to capacity reduction for the lack of an EU-wide deal on restructuring is just nationalistic and protectionist talk. In a free economy the more efficient one wins.

Idle overcapacity is of course a very costly business. In 2012 Peugeot burned $3 billion of cash, while in Europe Ford suffered losses of nearly $2 billion. With Opel, Renault, and Fiat, which together account for about 42 percent of EU car sales, these five companies had operating margins of between -3 percent and -9 percent[6] and all five confronted further job cuts and factory closures,[7] whether the sovereigns of the countries in which their factories were located liked it or not.

To implement its strategy of creating a motor vehicle group of global dimensions, Fiat focused on its 100 percent takeover of Chrysler, completed on January 2, 2014. The downside has been a most significant net debt increase. The buyout of Chrysler's minority investors has been financed with debt further weakening Fiat's balance sheet, and adding $4.6 billion[8] to Fiat's liabilities. This increases the Italian automakers' leverage to 1.3x (excluding pension funds). Furthermore, with €18 billion ($24.3 billion) of payables, Fiat's working capital position became way too stretched.[9]

Year-on-year, from the end of July 2012 to the end of July 2013, Fiat's net industrial debt swelled by nearly €2 billion ($2.7 billion) to €7.2 billion ($9.7 billion). Starting in 2009 with the acquisition of a Chrysler share Fiat paid a lot of money for an auto company that was close to the scrapyard when America's carmakers sought bankruptcy protection in the wake of the financial crisis. With the hindsight of five years of experience, however, it can be stated that the Chrysler acquisition strategy made sense.

The change started in 2004, when Sergio Marchionne, then Fiat's new boss, came in and turned around the aged carmaker. Chrysler's business in the US was vital to give the Fiat brand the benefit of size. Marchionne's view has been that to keep up with rivals like Toyota, GM, and Volkswagen, the merged Fiat-Chrysler must turn out more than 5 million cars a year, even better 6 million. So far, however, the numbers stand at about 70 percent of this latter goal.

Contrary to Daimler's takeover of Chrysler, which was a failure, the timing of Fiat's ownership has been good.[10] Chrysler had little of its own to offer in small cars and it needed Fiat to provide platforms like Alfa Romeo's Giulietta and its small engine technology, to comply with America's increasingly strict fuel-economy standards. As for Fiat it needed Chrysler not only for its global size but also to cover with its profits Fiat's own losses in Europe where the red ink continues to run.

This is bad news for the Italian economy and for the (frequently on strike) Italian workers, because the company may be washed away by the river of red ink. In an effort to turn around its fortunes, after gaining full control of Chrysler, Fiat is leaving Italy, at least on paper—after 115 years of uninterrupted operations in Torino. In mid-February 2014 Fiat's board voted to move:

- The parent's legal domicile to the Netherlands,
- Its tax residence to Britain, and
- Its main stock-market listing to New York.

This policy is not totally new. Fiat used it when its tractor unit was merged with an American rival and spun off as CNH Industrial. As for the choice of the Netherlands, it's a destination that is gaining popularity. When in 2013 New York–based Omnicom and Paris-based Publicis, two big advertising firms, announced a merger, they described their proposed Dutch holding structure as an "elegant solution" for anyone who was troubled by the question of location.

Both tax issues and flexible corporate laws have ensured that Holland becomes a location of choice. An example is the ability registered companies have to issue "loyalty shares," which confer extra voting rights on long-term shareholders. CNH Industrial Exor, the investment vehicle of the Agnellis, has an economic interest of 27 percent, but 40 percent of the votes.

As for the choice of a British tax residence, Britain's tax laws look with relative leniency on firms using complex solutions, allowing them to optimize payments between subsidiaries. This practice legally minimizes tax bills. Moreover, Britain levies no withholding tax on the distribution of dividends from foreign operations, which is an added bonus.

* * *

In June 2009 General Motors applied for Chapter 11 protection from creditors. That move triggered the largest industrial bankruptcy in American history. Fourteen months later, in August 2010, GM filed papers with the Securities and Exchange Commission to pave the way for an initial public offering before the end of that year. It also unveiled net earnings of $1.3 billion for three months ending June 2010, its second quarterly profit in a row and its best since 2004.

It is quite difficult to say what might have happened if GM and Chrysler had been allowed to go under. Most likely they would have taken down with them America's highly integrated network of car parts suppliers, thereby threatening the whole car industry. To avert this likelihood, the American and Canadian governments pumped some $50 billion in loans and equity into GM, giving it a stronger balance sheet. The auto manufacturer also:

- Laid off tens of thousands of workers, and
- Extracted concessions from the United Auto Workers (UAW) union.

Nicknamed Government Motors since the bailout, GM has been able to capture enough market share to survive, but it never returned to its past glory. Neither did it reimburse all of the government money because its equity did not recover enough. Indeed, in late November 2013, it was stated that the US government was on course to realize a $10 billion loss on its bailout of General Motors after it decided to sell its remaining 2.2 percent stake in the carmaker.

The American government's exit from GM's share register marked the end of five years of intense involvement in the country's auto industry. As for the $10 billion loss, it represents the US government's single largest realized loss from a bailout. The pros have argued that had the government not acted to support the automotive industry, the cost to the nation would have been substantial in terms of lost jobs, reduced economic production, lost tax revenue, and other consequences.

Not everybody buys that thesis, but taking it at face value permits us to calculate the consequences of a similar loss of about 20 percent of loaned capital in a scenario applied to Fiat-Chrysler. More precisely to the loans made to Fiat by banks and bondholders who bought its debt instruments enabling the auto company's turnaround as well as the Chrysler takeover.

5. The Bankruptcy of Detroit

Detroit was the domicile of the three big US carmakers: GM, Ford, and Chrysler. When two of them went bankrupt and Ford barely managed to survive without asking for salvage through taxpayer money, a city accustomed to being a big spender went bust. Indeed Detroit's financial problems were made worse when the city fathers and labor unions tried to fix unfunded pension shortfalls.

Detroit filed under Chapter 9 of the Bankruptcy Code, the section that applies to municipalities, on July 18, 2013. States must authorize municipalities to file for bankruptcy. As Detroit filed under the Federal Bankruptcy Code, federal law will generally override state law. Unlike corporate bankruptcies, however, the creditors cannot force municipalities into bankruptcy.

With the bankruptcy filing, present and future retirees will see cuts to the unfunded portions of their pensions. Healthcare benefits will also be trimmed. This has been (so far) the largest American city ever to file for bankruptcy in this century, its sorrows being compound by an economic crisis, chronic mismanagement, a shrinking population, and rapidly increasing legacy costs.

According to Rick Snyder, the governor of Michigan, the crisis had been brewing for more than two decades. Earlier on, the city was rich. GM, Ford, and Chrysler made in Detroit nearly all the cars sold in America. It was unavoidable that the crisis of the big three carmakers would hit the city. Poor governance did the rest.

Detroit's broken pensions and healthcare systems were in part based on an assumed 8 percent return on investment. Ironically, this is the range accepted by most US states and municipalities but it is totally unrealistic. Under the nearly zero interest rates instituted since 2009 by the Fed, even 2 percent would be rather too high for relatively risk-free investments. Fancy, indeed phantom, returns compounded pension plans' underfunding by justifying higher benefits and/or reduced employer contributions.

- Irresponsible assumptions on return on investment came back to haunt those who made them, and
- With instruments maturing in several years they will continue doing so for decades to come.

Indeed, a big chunk of the amount of debt taken on by Detroit was an attempt to top up its city employees' pension funds. It was also unsustainable. Like so many other municipalities, particularly in the US and in Italy, Detroit had played with derivatives as a way to solve its problems and it lost. At end of June 2013 the negative value of the derivatives bought by the city of Detroit was a cool \$300 million—with a large percentage of revenues eaten up by payments tied to borrowings and retiree obligations.

According to some estimates, by the time Detroit pays off the $1.4 billion in borrowing, the total bill from 2013 will be more than $2.7 billion. That's almost double the original debt, of which $770 million will be the derivatives. The mismanagement of city finances offers an explanation for why the state of Michigan first decided not to provide more help to Detroit and then decided to give some money. Critics said that this was an invitation for every other city and town in the state to be irresponsible in its financial management.

Theoretically, but only theoretically, it was cheaper for Detroit to issue a floating-rate debt and then fix its interest payments by buying an interest rate swap. Instead, it only bought an interest rate hedge to protect against sharply rising interest rates. These quickly turned into a problem because a downgrade in Detroit's credit rating in 2009 triggered a clause forcing the city to buy itself out of the deal. The cost was several hundred million dollars.

Both cost and debts matter but the city fathers and labor unions paid little attention to Detroit's unsupportable debt burden while they were desperate to discuss more goodies at the taxpayer's expense. It is indeed surprising how little care was exercised in connection with the growing debt overhang and the city's long-term liabilities.

This was not just a financial problem but also one of ethics, because large debts make a mockery of public interest and they invariably exacerbate social tensions—while defaults leave creditors with less capital than they thought. This hits pensioners, savers, suppliers, and bondholders particularly. One of the direct (and unavoidable) results is that income inequality rises, a fact that works against the touted social cohesion.

As misfortune never comes alone, the next step too was a financial blunder. Detroit thought it had averted a potential crisis by signing a deal that backed future payments with tax revenues from the city's casinos. The transaction transformed the investment banks that participated to the original deal (Merrill Lynch and UBS) from unsecured creditors to nearly secured, with greater claims in the wounded city's financial restructuring. The banks:

- Positioned themselves as power brokers, and
- Signed a restructuring deal that would pay them only 75 percent of the $300 million they are owed, if Detroit came up with the money before November 2013, which it could do only with federal funds.

But for Washington to fund a bankrupt city would have been against the letter of the US constitution. Besides Detroit's bankruptcy was unlikely to produce global contagion, even if its financial difficulties raised concerns about unpredictable knock-on effects given the size of the diverse US municipal bonds market. Moreover, unlike the 2007 case with subprimes, the banks were not so exposed in connection to Detroit's bankruptcy. Hence it was hard to see where the systemic risk would come from.

Altogether Detroit had a guesstimated $18 billion in outstanding debt, or $27,000 for each resident,[11] of which more than half was unfunded retirement benefits, while part of the total debt was insured.[12] Most of the insurers of Detroit debt appeared to be adequately capitalized to make good on these payments, though experts said that a series of other large-scale defaults might threaten the insurers. (Only one of them, which insured about $760 million of Detroit debt, appeared unable to fully meet its commitments.[13])

Motown has seen a "perfect storm of mistakes at every level," said Jennifer Bradley of the Brookings Institution. Its leaders ran up debts that a shrinking population could never pay and those debts forced the city to raise taxes and cut services.[14] Other cities and towns should take notice to avoid repeating Detroit's errors.

Moreover, quite curiously, the city was hostile to enterprise. The mayor was said to be leading a campaign to shut down small businesses that did not comply with regulations, instead of fixing the city's finances. Instead of looking in a realistic manner at the slide toward bankruptcy, pensioners and Detroit's public sector unions argued that all sorts of curious contracts, along with the pension and healthcare benefits, were rights explicitly guaranteed by the Michigan state constitution.

What they failed to account for were the clauses of the US federal constitution and the fact that if Detroit's beneficiaries were middle class, the beneficial owners of most of Detroit's municipal bonds were also middle class. That made bankruptcy a lose-lose situation. Over and above that was the case of unexpected surprises by the authority over defaults the US constitution gives the federal courts.[15]

The US Supreme Court has also ruled that unlike Treasury bills and bonds, social security benefits are not full faith and credit obligations of the federal government. Hence, Washington did not have to intervene. Still, on September 27, 2013, a group of cabinet ministers came from Washington to Detroit offering $300 million in federal and private aid. The housing secretary offered cash to knock down abandoned buildings. Others promised money to mend and police the city's crime-infested streets as well as to build cheap houses. As for Barack Obama he was criticized for his failure to rescue the city while he had bailed out its carmakers.

Little attention was paid to the fact that Congress was in no mood for a bailout. If Uncle Sam rescued one bankrupt city all the others and several states, too, would demand federal handouts. In addition, donors looked at the future rather than trying to fix bottomless legacy issues. In short, none of the money being promised to Detroit was earmarked to pay off the city's debts.

In the meantime legal costs accumulated. A law firm representing the city has charged it $1.4 million. The advisers appointed to keep track of fees for lawyers and consultants filed a big invoice for their first month on the job. On September 27, 2013, Detroit's emergency manager (in charge of its bankruptcy) called for the pension scheme for city workers to be frozen, after an audit uncovered serious problems.

Many common citizens are surprised to learn that the car industry, which in a few years hopes to bring self-driving vehicles to our streets, is not able to help the city of Detroit solve its problems. This argument however forgets that the auto industry itself is deeply wounded as well as demoralized because it looks as if it has entered a slow, fatal, apparently irreversible process of decay of old structures while new ones have not been, as yet, properly defined, let alone elaborated at a reasonable level of detail.

6. The Crisis of European Flag Carriers

European airlines have been confronted by diverging fortunes. With the possible exception of Lufthansa, the flag carriers find it difficult to make a living while, in contrast, the leading low-cost airlines are thriving. While the economic crisis is one of the factors, it can by no means be said to be the only reason for this divergence in fortunes. Efficiency makes the difference.

One factor responsible for the economic downturn of flag carriers is that both business people and common citizens are saving money when traveling inside the European Union. They do so by flying with budget airlines. EasyJet and Ryanair are oft-cited examples, the latter being the EU's largest airline by revenue. On the flag-carrier side, Lufthansa Europe's largest low-cost airline by revenue, issues profit warnings from time to time, while Air France-KLM, the second-largest EU flag carrier, also expects an operating loss from time to time.

Experts say that low-cost carriers are well placed to exploit the collapse of Europe's market for legacy airlines. Swissair was among the first to go while by the end of 2012 Malev Hungarian Airlines ceased operations because its finances had turned negative. SAS was saved at the eleventh hour, after extracting major concessions from the labor unions, which permitted it to downsize its costs. Analysts are presently predicting that more airline failures will happen in Europe because not only are there simply too many carriers, but they are also confronted by a combination of:

- A deteriorating economic environment,
- High personnel costs, and
- Increasing fuel prices, undermining high-cost flag airlines.

In the past, the European legacy carriers have expected bailouts from governments as a matter of course. This recently happened with Alitalia when it required a bailout to the tune of €300 million ($405 million), but the governments themselves are now short of cash and some are lacking both the will and the funds for handouts. Neither is the ownership of a state airline a matter of prestige as it used to be after World War II.

In the prevailing business environment, experts envisage a continuation of airline bankruptcies and industry consolidation, having estimated that some of Europe's airlines have a market share of less than 1 percent when measured by the number of seats they provide on the region's short-haul routes. In other terms their income stream is trivial but costs are still running high.

Such estimates and the projections following them use as reference the way American carriers—for example, American Airlines,[16] Southwest Airlines, Delta, and United-Continental—consolidated or got out of business. These four US big carriers control roughly 85 percent of domestic seating capacity while the top five in Europe—Lufthansa, Air France-KLM, International Airlines Group (IAG; British Airways and Iberia), EasyJet, and Ryanair—control about 45 percent of intra-EU capacity.

The experts' projection is that Lufthansa, Air France-KLM and IAG will survive because they have profitable long-haul routes. In contrast, other European carriers, essentially the second-tier legacy airlines, are at risk. They are simply nonviable in the longer term.

To be a survivor an air carrier will have to watch its costs line most carefully. In 2011 Air France lost €800 million ($1.08 billion). To bring costs under control, the company had to redimension itself and project economies of €2 billion ($2.7 billion) for 2012 and 2013, taking action before costs ran out of control.

That allowed some flexibility to Air France-KLM management when, in January 2012, it decided to slash investment and enforce immediate cost savings by freezing wages and recruitment. Notice that this was not the first attempt to turn round the fortunes of the struggling Franco-Dutch airline.

A root-and-branch restructuring plan put the Air France-KLM new management on a collision course with French labor unions. Restructuring and cost control became better accepted after the legacy carrier ousted its chief executive because the company was rapidly losing ground to its two large European rivals, Germany's Lufthansa and IAG.

At the end of February 2013, Alitalia too ditched its chief executive, while analysts speculated about whether or not Italy's flag carrier could remain independent as its losses mounted and its market share continued to shrink. Officially, the company said its CEO had resigned from his position and until a new chief executive is appointed the board had given the position to an interim chairman. This resignation came as the airline announced a €280 million ($380 million) net loss in 2012, compared to a quarter of that money in 2011.

Analysts commented that a political power vacuum in Rome removed government opposition to a sale of a greater stake in Alitalia to Air France-KLM. The French-Dutch group, which owns a quarter of Alitalia, was thwarted in its attempts to take over the Italian airline in 2008 after opposition from Italian labor unions and the then Berlusconi government. In 2013, when asked to take another look at the takeover, Air France-KLM stated that it would absorb Alitalia only if and when its €300 billion in debts was paid off. After some hesitation, the Letta government was happy to oblige using taxpayer money.

In conclusion, survivors in the European air carrier business will be those that are efficient, with low leveraging, keep a check on employee costs (as percent of operating costs), and have a healthy operating margin. Ryanair is at the top of this classification with, respectively, 14 percent in leveraging, 11.8 percent in employee costs, and 15.6 percent in operating margin. It is followed by EasyJet with 19 percent, 12.8 percent, and 7.8 percent.

Compared to these statistics, which document a sound level of efficiency, the flag carriers are not faring so well. The better off is Lufthansa with a gearing of 27 percent, employee costs as percent of operating costs of 21.9 percent, and an operating margin of 3.6 percent (compare this to the 15.6 percent of Ryanair). In 2014 Lufthansa's weakness has been repeated pilot strikes. Next is IAG with, respectively 47 percent, 24.4 percent, and 3.3 percent. The worst off is Air France-KLM with 66 percent, 30.1 percent, and –1.5 percent—which essentially means red ink.[17] The French and Dutch governments put their hands in their taxpayers' pockets to cover the difference.

12

Ethics, Opportunities, and Risks with Information Technology

1. Software Challenges

Albert Einstein once said he feared the day that technology will surpass our human interaction; when this happens the world will have a generation of idiots. While that day has not yet arrived, what confronts us at present is a swarm of software challenges and their aftermath. The more sophisticated a software, the greater the opportunities it opens up but also the risks associated with its implementation—from crashes to security.

In early August 2012 an error by a US-based trader at RBS Securities caused a sharp and unexpected rise in the euro against the Swiss franc. The transaction that took place on the foreign exchange platform of the Royal Bank of Scotland briefly pushed the euro up to a five-month high against the Swiss franc. This created a stir because it triggered a wave of computer-generated (algorithmic) trades from other banks.

The transactional mistake, which was almost immediately spotted and corrected, occurred amid heightened concern over market mishaps after computer trading gone awry in the US stock market nearly caused Knight Capital to go under, financially damaged by $440 million losses. With the RBS mishap, too, the market went berserk, said a trader of the exchange rate error.

Blackstone, Getco, Jefferies, Stephens Financial, Stifel Financial, and TD Ameritrade stepped in with a lifeline for Knight Capital, and computerized trading system malfunctioning did not threaten to send the company into bankruptcy. But it was a close call and the convertibles issued by Knight gave the buyers the right to purchase 267 million of its shares at $1.50, about half of the trading price prior to the snafu. As a result of it the buyers got a hefty 70 percent of Knight at a valuation of less than five times the year's net income in 2011.

Critics said that with this sort of technology risk there is a likelihood of a sudden unwanted exposure not just for one financial firm but also for the whole industry. Until rather recently trading was concentrated in trading pits; high technology revolutionized the securities business with the result that computer systems dominate stock market trading now. Online trading has advantages; the downside however is not limited to only a computer glitch. The greater risk is a blackout.

Should the software producer be legally responsible for accidents created by a malfunctioning of his artifact in the client's premises or in the cloud? There can be no general answer to this query. Every failure has its own characteristics. It might be a human error at the client's site, an incompatibility between software routines produced and sold by different vendors but which have to work in unison; a problem of integration under the operating system used by the client, or by the data warehouse (see section 3), or some other reason.

In the case of the aforementioned mishap at the Royal Bank of Scotland, the board had to decide whether to take legal action against the software firm whose program created the trouble. A similar decision had to be made at RBS in June 2012 after a system failure left millions of the bank's customers without access to their accounts. That failure affected up to 17 million customers and cost the bank millions of pounds in overtime.

For his part, Mervyn King, the governor of the Bank of England, called for an investigation by the Financial Services Authority (FSA) into the systems failure. "Once the current difficulties are over, then we will need the FSA to go in and carry out a very detailed investigation to find out, first of all, what went wrong and then, perhaps even more importantly, why it took so long to recover," King said in a deposition at the Treasury committee in Parliament.[1]

When a computer system crashes, whether for software, hardware, or operational reasons, it leaves the user organization with a rapidly snowballing backlog of transactions. Companies should prepare themselves for system failure and test their restart and recovery procedures through drills.

- They should be proactive in matters of operational risk rather than wait for a debacle as a wake-up call, and
- They should keep on updating their computers and communications system rather than continue with dated, worn-out solutions prone to produce a ripple effect for the firm and its clients.

Information system management is a steady job, not one that is done every three or five years. Another tough problem for many of the big banks is that they have expanded rapidly largely through acquisitions. This results in incompatible systems. Only a few big banks have opted for new IT systems. The majority has chosen the more laborious and potentially disruptive process of keeping their legacy complex web of thousands of programs linked by fragile interfaces.

- Layering subsystems on subsystems, and
- Devoting no time and effort to ascertain how well all work together.

The challenge is to provide a nondisruptive path to new and advanced functionality. An interim solution may involve the enabling of legacy systems but the strategic approach is that of transforming core business functions to a fully online environment through a forward-looking action, always paying attention to:

- Reliability,
- Security (section 2), and
- The avoidance of failures at the time of transition.

Efficiency is at a premium and this is true not only of banks but also of all firms. A system failure in a service industry other than banking took place on April 10, 2002, when Heathrow's air traffic control suffered its second computer breakdown in two weeks, causing widespread disruption and delays of up to three hours for early morning flights. National Air Traffic Services said the computer failure had occurred in the flight data processing subsystem, which collapsed for 15 minutes at 6:05a.m.

The timeout was nearly two and a half hours as flight capacity was not fully restored until 8:30a.m. The computer failure was an embarrassment for Heathrow Airport and it came when the entity was wrestling with severe financial problems following a sharp decline in air traffic since the September 11, 2001, terrorist attacks in New York and Washington.

Software accuracy and efficiency means meeting user requirements for such systems attributes as functionality, performance, and maintainability. By contrast, software quality focuses on the absence of bugs as well as latent errors and on fault tolerance. For a user organization efficiency, accuracy, and quality of computer support are very important for reasons of competitiveness.

Efficiency, accuracy, and quality are promoted by the effectiveness of software interfaces. Because user requirements change, system configuration must also be flexible or its dependability characteristics will deteriorate over time—as it happens practically every day with billions of lines of Cobol and Fortran codes, which, for all practical purposes, have become obsolete as:

- Programming languages, and
- Functional modules.

A basic problem confronted by all computer users, not just banks, is that the majority typically built their systems in the 1960s or 1970s. But in the past 40 years the implementation landscape has changed dramatically, first with VAXes and PCs, then with client servers and sophisticated software. This has been a rapid, not a relatively gradual, evolution, with the result that following up without altering the foundations solutions has been a slow, costly, and confused process.

The time, risk, and complexity of extending old incompatible structures are too much of a burden. Instead, there should be a steady renewal effort, making a new system both cost effective and resilient. There is no sense in networks squeezed by the increasing volume and complexity of operations. Antiquated, brittle systems tied to more modern systems are the worst possible solution.

When adversity hits, the time and effort that has to be spent on corrections is out of proportion with the obtained result. In the case of the late June 2012 system crash, the Royal Bank of Scotland said that the initial problem was rectified within a couple of days but it lost track of which payments had been processed and had to draft in a team to check them manually. With an accumulated backlog of about 20 million payments every day this work was seemed monumental. At one point the bank had 100 million unprocessed payments.[2]

2. Big Data

The challenges of having and exploiting online databases are as old as scientific computing and business data processing. Since the mid-1950s, in six decades of intensifying computer usage, only the pioneers have been keen to actively investigate and test each idea, each concept, and each data management approach against their understanding of what is computationally practical. The achievement of a holistic view of database contents has been a core issue in this effort, providing plenty of opportunities and experience within each particular field of applications.

By being able to run their business better than their competitors, companies that assumed leadership in database management and online mining benefited handsomely from their investment. Those in leadership position continued being ahead of the curve, particularly when it came to capturing and analyzing data on everything:

- From customer behavior
- To production line efficiencies.

With advancement in data mining technology there is plenty of room to improve further, embracing state-of-the-art system solutions in monitoring analyzing and decision making. The exploitation of *Big Data* is fast becoming the cornerstone to manufacturing revival, though there are also headwinds ranging from poor education of IT specialists to an inadequate infrastructure as well as the persistence of a bulk of legacy computer solutions that are generally ineffectual.

Online mining of big data provides the basis for greater productivity. Its importance is attested by the steady evolution of database management. To answer the need for greater flexibility and efficiency in database usage, hierarchical database systems have been replaced by the relational database mode and its associated implementations. With these exploited more or less to their limits:

- New database technologies have been developed based on the object-oriented model, and
- Further requirements have been advanced with unstructured information elements as document handling came to the fore (see the discussion on Autonomy in chapter 11).

The advent of newer and more effective solutions in information technology at large, and most particularly in the exploitation of databases, has been part of the wave of change leading to competitive advantages. One of the critical benefits of object orientation, for example, has been the simplification achieved through semantics and the ability to give meaning to our queries.

This is most important when communicating with the sprawling distributed databases that we have constructed and use daily. It is also a stepping stone toward online document handling. The following domains offer the best opportunities for the implementation of such advances:

- Computer-aided design (CAD)
- Computer-aided manufacturing (CAM)
- Computer-integrated manufacturing (CIM)
- Complex market-oriented operations (market and customer patterns)

- New financial instruments (derivatives, securitizations)
- Cross-functional projects (risk management)
- Social networking (fast expanding)
- Healthcare applications
- Cross-departmental projects, for cost control and other objectives
- Graphical and cartographical implementations
- Military and intelligence operations at large
- Image processing, digital video, and photography
- The next big steps in office automation

In the background of these applications is an explosion of online data coupled with the need for their efficient exploitation. That's the challenge of *Big Data*. Just to take a couple of examples, one billion smartphones were sold in 2013 alone.[3] Along with units in operation from previous years, these generate constant streams of data, including their location and usage.

As another example, big oil companies add 2 terabytes of data *each day* from three-dimensional seismic maps of their oil and gas fields. For their part, some supermarket networks create up to 1 million rows of new transaction records in their database *every hour*. This is, for instance, the case with Walmart.

Big data developments are way ahead of those that started in the 1990s, whose competitiveness rested on networked enterprise at the desk level. The contribution of the end-to-end solutions is identified by two of its basic characteristics: fully networked resources, so that there was no single point of failure, and the fact that its prevailing architecture was not limited by the location and size of one database. Additional requirements that now prevail with Big Data include:

- Effective approaches featuring contained hardware, software, and personnel costs,
- Open access to all data by every authorized person, at all times, in a networked sense,
- The need for adopted solutions to be both secure and reliable
- A policy that resources attached to the network should be scalable; and
- The strategy of keeping the architecture flexible, permitting the integration of heterogeneous databases.

Able solutions, of course, do not appear as a matter of course. They have to be thoroughly studied and experimented with, and they can be successfully implemented only if the organization stresses on computer literacy for everybody. On the technical side, the prerequisites needed are:

- Intelligent networks,
- Large distributed databases,
- Effective visualization,
- High-performance computers,
- Simulators and knowledge of engineering artifacts.

None of these prerequisites relates only to systems. Instead, embedded in each is the need for comprehensive approaches to effective applications where human elements play a key role, assisted through online mining and exploitation of unstructured documents in order to explore and promote:

- Customer relationships,
- Market penetration,
- Product impact,
- Functional efficiency,
- Analysis of business opportunities,
- Profit and loss by customer, by product, and by areas of operation,
- Cost control, and
- Risk management.

To a large part, this effort is evolutionary, but the pace of change has accelerated. From the beginning, database mining has been closely connected to the tools available for logical database design, or architecturing, and the management of the distributed database system as a whole. The infrastructure for both these layers has been provided by a system of interconnected databases developed by leading organizations over the years.

A basic prerequisite to effective database mining was that the system be designed in a very flexible manner, so that it can respond to changing requirements without interruptions for major retooling. Database mining operations should be seen from a dual perspective as the term applies both to the underlying concept and to the processes addressing many applications from design prerequisites resulting from distributed study centers to the implementation of marketing chores and the recognition of patterns. Financial databases have particularly benefited; applications such as cost control and risk management are examples.

3. Metadata and Descriptive Analytics

As nothing is static in IT, or for that matter in business and industry at large, attention should steadily be paid to new developments and to the need for more sophisticated solutions. As section 2 brought to the reader's attention, our time is one of data explosion. According to the International Data Corporation the total amount of digital information has been growing by 60 percent annually, on global basis, and the growth rate is likely to remain rapid with:

- Websites tracking every click and page view,
- A drive of businesses to capture and analyze data about customers, products, transactions, inventory, and logistics,
- Rapid proliferation of smartphones, tablets, and sensors generating constant streams of data,
- Facial recognition data, assisted by intelligent software,
- Digital video and photography recording people's lives, and
- Social networking and its rapidly growing user content.[4]

Several factors differentiate big data differs from traditional databases including structure, volume, rate, variety, and value. The volume of the data is growing exponentially including information elements that in the past were not captured and stored—let alone efficiently explored. Recently, however, companies have begun to realize the value of retaining and analyzing data that had often gone to the wastebasket.

For its part the generated and collected rate of growth of data is now much faster. It is a continuous stream compared to legacy datasets, and it comes from a wide variety of sources. According to expert opinions not only has Big Data the potential for delivering value, but analytics is also becoming a key competitive advantage,

- Allowing companies to gain a better understanding of their market and of their performance, and
- Making predictions by identifying trends and patterns.

Descriptive analytics helps to uncover developing or even hidden patterns, permitting better-informed business decisions to be made, improving operations, and promoting the profitability of ongoing transactions. According to some estimates, in the US alone enough data is stored in a year to fill 70,000 Libraries of Congress. The world's billions of mobile phone users (a growing number of whom own smartphones) have turned themselves into data streams.

A similar statement is valid in connection to military and intelligence operations, all the way to the invasion of privacy. This, of course, poses legal problems, which is also true of the extensive usage for marketing purposes. Ethics connected to Big Data and descriptive analytics is a matter far from having been settled in the courts. As 2013 came to a close two American federal judges offered sharply differing views on the legality of an NSA program that hunts for *metadata*—data about data[5]—on most telephone calls to, from, or within America.

- Sitting in a district court in Washington, DC, the first judge called metadata collection “almost Orwellian” and probably unconstitutional.
- The second US judge, sitting in New York, called the NSA’s descriptive analytics of phone records quite legal, adding that had metadata been collected before 9/11 the agency might have joined the dots between intercepted calls to al-Qaeda.[6]

It does not need explaining that, at least in the US, higher courts will now have to weigh in, all the way to the Supreme Court. Other jurisdictions may well have different opinions. We are just at the beginning of a debate on the damage descriptive analytics can do to a democracy when used for political reasons.

People who assumed that Barack Obama opposed the policies of George W. Bush have been badly mistaken (see also section 8). They willingly forget that practically everyone spies on everyone else. Still, public anger in London, Berlin, Paris, Brussels, and elsewhere is real enough. Citizens who cherish their privacy and their freedom are not looking kindly at their invasion.

Obama also faces a domestic fallout. His approval ratings among young Americans fell markedly in 2013, making a once-loyal age cohort look much more like adult Americans. But is the Orwellian way, to which the Washington federal judge made reference, the one advanced technology opens for the future? Prior to answering this question one has to ask where are the ethical values embedded in the Constitution?

Expediency is taking over with state secrets and national interests used as justification. For business and industrial operations, the fastest growing and most pressing need is the exploitation of data embedded in documents that classical databases cannot capture. The challenge is unstructured data that includes the contents of reports, videos, presentations, emails, and more. Organizations have a growing need to understand unstructured data and there are abundant potential uses for unstructured information. All sort of firms are eager to:

- Identify new consumer trends,
- Gauge customer sentiment toward products and brands, and
- Build more complete customer profiles.

This can be achieved by combining transactions stored in structured databases with unstructured information and the analysis of patterns. Pattern recognition is not an exact science, and pattern interpretation involves many fuzzy engineering concepts. Patterning always occurs on curved surfaces.

The fuzzy sets are *qualifiers*. The exploration of spatial and temporal relations has become particularly important in dealing with idealized abstractions, while inference permits the handling of uncertainties. Ambiguous and ill-defined information is typical of human cognition and reasoning: We see words and numbers and try to derive a pattern out of them. Typically pattern recognition is done by the brain's right hemisphere. In this process, fuzziness defines a state of mind that says: "I may not know exactly what I want, but I can describe the process of a weighted decision." The bearing of this approach is underlined by the fact that few real-life business decisions can be described with yes/no answers. Whether we appreciate it or not, they usually involve a pattern construction that most often is characterized by fuzziness, which in turn involves:

- *Imprecision,* which refers to lack of specificity of contents of an information element; for instance, an inflation rate between 5 percent and 8 percent per year.
- *Vagueness,* which results in lack of sharp boundaries of an object, whether this is denoted by approximate numbers or by words. For example, if we say, "A low inflation rate is good," then the inflation rate is context dependent but ill defined.
- *Uncertainty,* which refers to our partial ignorance of specificity of a certain information element and its description. For instance, the probability of getting a 6 by throwing a fair die is 1/6. There is no certainty that a 6 will show up.

Having said this, the strategic value of handling unstructured information is difficult to assess without considering its feasibility and dependability. *If* the desired results are technologically unfeasible, *then* strategic value does not exist. Current breakthroughs, however, indicate that as investigative tools descriptive analytics and pattern recognition can provide rather significant results, going beyond the limits of legacy software engineering and database mining methods.

An important criterion is integrity in assessing the outcome of tests, detailed architectural analyses (currently missing), and merits of various alternative approaches. Given all the unknowns and uncertainties in technology, the decision process in handling unstructured data needs to be much more thoughtful, careful, patient, and depoliticized. It should:

- Observe ethical values,
- Openly address the issues raised by its critics, rather than attempting to hide them,
- Overcome the difficulties of defending against unanticipated types of challenges, and
- Avoid relying solely on technological solutions for problems with strong nontechnological components.

Stated in a different way, Big Data, metadata, and descriptive analytics raise many issues similar to but bigger than those of more classical databases. Some professionals frequently allow the beauty of their mathematical models to obscure the unreliability of the numbers they feed into them (garbage in, garbage out). By so doing they can easily miss the big picture in their pursuit of ever more granular data. At the same time, there is no denying that Big Data is making obsolete, or outright disrupting, established methodologies and business models.

4. Cloud Computing

No two people will completely agree on what cloud computing *is* and what it *is not*, or even on the origin of the term. To some the underlying concept looks too general, the domain too broad, and the competitors too diverse in their business background and even more so in their size. Not all of the people expressing such reservations are the cloud's critics, though they tend to think that it is a sales gimmick rather than a technological breakthrough.

The roots of cloud computing's functionality are also open to debate. According to one definition, which is not generally accepted, the concept underpinning cloud computing should be found in advances in grid computing used for scientific calculations. The term *grid computing* evolved in connection to shared high-performance computing facilities, which have been *multitenant*. Database clustering for multiple users from different firms was instrumental in evolving features like dynamic resources scheduling and load balancing, which:

- Increased resource utilization, and
- Eventually led to the cloud computing concept.

These advances have enabled information technology providers to use relatively low-cost commodity servers to market computing and data storage power on a wider basis. The combination of commodity software and easy online access has allowed user organizations to pool and allocate programming resources *onDemand* (or Software as a Service, SaaS; section 5) rather than dedicating stacks of *onPremises* software to specific tasks, the old legacy way. But not all offers have been efficient or convincing.

The pros maintain their positive stance on cloud computing saying that the whole process is at an inflection point due to the confluence of supply and demand. On the supply side, the mainstream adoption of virtualization technology and increased availability of broadband Internet (at falling prices) should lead to greater availability of cloud services. On the demand side, they see cloud computing's adoption by enterprises due to its potential cost savings.

Conveniently forgotten are the cloud security issues, which have grown with time and with the growth in the population of users. The downside of spending on cloud services is that system outings will be paid by all of their subscribers—and that will change the generally positive view one gets from past statistics.

Whether because of a terrorist attack or any other wide-ranging reason(s), online systems are vulnerable, and this has not been paid the attention it deserves by their enthusiasts. Not just one but many concerns have also been raised about the weak measures that companies, including IT service firms, employ to protect and secure data over the Internet. Cloud computing users confront two challenges:

- Pure security issues, and
- The reliability of the system.

When websites crash, corporate data can be jeopardized. Backup procedures are not always up to standard, while lax security ensures that hackers gain access to personal information of millions of customers, including credit card details.

Beyond the need to apply rigorous principles of computer security, providers of online services should always be open with customers when things go wrong. It helps precious little to remain tight-lipped when security breaches become known.

The users of cloud computing and other online services should also get their act together. They should not trust third parties with confidential information and should not use the same passwords on multiple online systems. In addition, user organizations should be aware that plenty of information is handled through cloud computing, and even simpler networks, which used to be private but have now become semipublic.

In addition, user organizations must be aware of the risks of being too reliant on a single supplier, and look at ways to distribute work across multiple providers. This makes so much more complex (and costly) the management of information technology but being unaware of the risk is the worst possible policy a company can adopt. An added factor is that big systems, and cloud computing is a big system, tend to become obsolete. Complacency is an enemy of business, and it comes disguised in several forms.

Take IBM as an example. Even if its profits have kept rising, many investors have become doubtful about where its future growth will come from, so its shares have fallen by about 13 percent since their high-water mark of March 2013, even if technology stocks and the broader stock market have gone up. Stanley Druckenmiller, a hedge-fund manager, said that his bet against the firm was one of the more higher-probability shorts he has seen in years, because "IBM is old technology being replaced by cloud technology."[7]

A short time ago analysts at CSFB, the investment bank, stated that IBM is making over half of its earnings gains from "lower-quality means" such as share buy-backs and cost cutting. According to *Bloomberg News*, IBM is also using low-tax burdens in Holland for tax optimization.[8] The management of IBM insists it remains on target. Acquisitions of cloud computing rising stars are also on the menu. An example is IBM's purchase in June 2013 of Softlayer for an estimated $2 billion, following the loss to Amazon of a battle to win a contract to build a private cloud for the CIA.

In parallel to their cloud computing offerings, competitors in the technology industry have another pet project that makes even less sense. This is the so-called *Internet of Things* (IOT) which made its public debut of new gear in the first week of January 2014 in the Consumer Electronics Show (CES) in Las Vegas. This 2014 edition was heavily laden with wearable technology and backed the concept of nearly everything under the sun being a connected device such as an appliance or door opener served by cloud computing. Other projected applications, too, are trivialities such as:

- What temperature is the thermostat set at?
- Are my smoke and CO_2 detectors functioning normally?
- Is the electricity on in the house? Are lights on or off?
- Is the front door locked or unlocked and/or the garage door open or closed?
- Are the coffee pot and slow cooker scheduled to go on at a certain working hour or not?

If people are willing to pay for that sort of information or low return "service" to be provided online, *then* they are throwing their money out of the window. It looks as if with the unloading of inefficient old EDP applications are companies looking for anything "new," even if it is silly, to sustain their profits. That's not technology. It's the kitchen's sink.

On a more positive note a better way of looking at cloud computing is that it represents IT services in which shared hardware, software, and infrastructure are provided to computers and other devices on demand. A virtualization process underpinning such offers includes runtime application's middleware, databases, other services and, of course, networking.

For the pros cloud computing is the solution, representing the borderless information utility they have always wanted. In their judgment it enables companies to cast away their legacy systems that are technologically outdated and are restricting the development of business opportunities—and therefore profits. In its broader definition of component parts, the cloud computing landscape rests on four pillars:

- Applications,
- Platforms,
- Infrastructure, and
- Enabling services.

The use of commodity software is not new. The novelty lies in its (at long last) more general acceptance by business and industry (section 5). If done in an efficient manner, and only then, can its wider employment eliminate the arduous and costly process of software deployment including provisioning, configuring, testing, and securing new applications as well as, most importantly, their costly maintenance. It is heartbreaking to see college graduates spending their time maintaining programs written before they were born.

What the preceding three paragraphs have described is the "ideal" solution. Very few companies capitalize on it. The majority are relegating their data processing to cloud computing without counting the risks they are taking.

They don't even take advantage of commodity software, even if software maintenance has always been a large part of overall IT costs. Notice as well that commodity software has preceded, by more than three decades, cloud computing, promoting productivity, timeliness, and accuracy in both personal and business applications when and where it was properly adopted.

Due to the confluence of supply and demand factors several IT professionals look at cloud computing as an inflection point. This is exaggerated. Others see it as a way of eliminating private data center(s) (owned by a company) while benefiting from the adoption of virtualization technology and increased availability of broadband Internet at falling costs. That's an opportunistic approach and it is far from certain that benefits will indeed materialize.

Neither the pros nor the opportunists properly account for the risk associated with cloud computing. Moreover, the talk about lower costs (compared to private data centers) is just that: talk. Potential cost savings are of course an important issue, but they are also elusive when backup and other expenses are counted in. Neither does cloud computing offer exceptional business opportunities as some people suggest.

Inflection point or not cloud computing is changing the nature of competition within the computer industry. Since the last decade of the twentieth century technological developments have pushed computing power away from central hubs: first from mainframes to minicomputers, and then to PCs. Now cloud computing is pulling power back to the center in some respects, but it is also pushing it even further away in others with the result that user organizations lose track of where their data is: in Alaska, in Siberia, or somewhere else.

5. OnDemand and OnPremises

The *onDemand* practice has advantages. Access to computing resources is typically charged on a pay-as-you-go basis avoiding upfront costs required for resource-intensive variable workloads. Essentially, on one hand, cloud computing means that a nearly total IT outsourcing basis is favored by firms that have been unhappy with their in-house, *onPremises*[9] installation because of its mismanagement. On the other hand many companies don't pay attention to the fact that:

- Software as a Service (SaaS)
- Platform as a Service (PaaS) and
- Infrastructure as a Service (IaaS)

are solutions that can be applied with onPremises IT installations, provided that the information technology professionals stop reinventing the wheel and adopt commodity software. That's something they have by and large refused because of the fear of losing their jobs, until with cloud computing their jobs moved to the site of computing services providers.

SaaS is software up and running, available as a commodity offering and able to provide for a wide range of implementations at a fraction of the cost of in-house application developments. Also onPremises, PaaS assures an application development environment where users can develop and deploy applications of greater sophistication at a much lower cost than using obsolete legacy languages like Cobol, which in some opinions, has become a sort of criminal offense in IT (the critics are right).

In a similar vein commodity infrastructure (as a service, IaaS) offers user organizations a virtual environment allowing the in-house professionals to concentrate on other tasks, like the challenges associated with Big Data (sections 2 and 3). Correctly used, IaaS offers access to additional system infrastructure—mostly hardware such as servers and storage—when this becomes necessary.

User organizations should be aware that the cost of cloud computing is not only dollars and cents. Security and reliability are two leading reasons behind this statement, and both have associated costs that are rarely, if ever, accounted for. Loss of control over the basic infrastructure is another issue. Companies looking to reposition themselves in a changing information technology environment must account for all of the costs and risks that go along with it, not only the opportunities.

In terms of opportunities, it goes without saying that some organizations are more suited to use cloud computing than others. Among the determinant factors are the size of the customer, the level of needed security, and whether the software application is a core routine used across different departments of the user organization. Also important is the level of integration of a software product has with other third party apps. Till now, interconnectivity between cloud and onPremise applications is patchy.

If the software integrates with a host of other packages like, for instance, Enterprise Resource Planning (ERP), *then* the risk of a disruption is much less. *If* extensive work is needed to obtain integration, *then* this operation may turn on its head in terms of economics. It is not without a reason that three areas that have so far dominated cloud computing contracts are characterized by a certain independence:

- Customer relationship management,
- Supply chain operations, and
- Human capital applications.

On the contrary, business intelligence and financials tend to be kept in-house. These are sensitive applications and many companies will not pay with insecurity for their ability to tap the savings economies of scale that the cloud might provide. For security reasons customers may look to alternatives like an onPremise commodity.

Among themselves, the reasons explained in the preceding paragraphs tell why, as of October 2013, cloud computing commanded 12 percent of money spent on total software applications.[10] This is much less than what intuitively comes to mind by listening to the publicized great merits of cloud computing drummed up by the pros. The percentage is higher in America reaching about 16 percent and lower in Europe—just over 10 percent. It is lower in emerging Asia (about 5 percent).

On a worldwide frame of reference, compared to global usage, the US market represents nearly 60 percent of spending on cloud-based software apps. With the exception of Britain, in Europe commodity applications must confront the language barrier, while in Asia companies prefer mainly onPremise IT installations.

For years, many experts expect small and medium size enterprises (SMEs) to be the most open to switching to cloud computing. This sounds logical except for the fact that the SMEs are also among the more conservative companies, many of them being still family-owned firms that will not relegate their data processing to cloud computing vendors, no matter what the latter might be telling them.

While there always exist exceptions SMEs tend to be traditionalists. They work hard to survive and count twice before using innovation to drive their business strategy. The master in this domain is Silicon Valley. Its companies do not have generally better concepts, and its people are not smarter than the rest of the world, but Silicon Valley firms have the edge in:

- Developing new product ideas, and
- Executing them faster than their competitors.

The SMEs' algorithm is very simple:

$$\text{Success} = \text{Talent} \times \text{Drive} \times \text{Opportunity}$$

A "plus" is the Silicon Valley's culture that celebrates the achievement of individuals, making people drive themselves faster with the will to succeed in what they do. This process may look untidy if one uses old standards to judge it, but it delivers significant results. The challenger becomes more competitive than the incumbent.

In conclusion, in a market-orientation sense, likely advantages to be derived from cloud computing are not cast in stone. Established software companies like Microsoft and Oracle that have tried, not so successfully, to join the cloud, confronted major challenges. Both have been beneficiaries of the client server model that took hold through the 1990s, but like mainframe vendors of old they did not make the needed effort to drop their original business model and reinvent themselves. This provided opportunities for other big computer users like Amazon, which were quick in grasping the profits they could make by selling as a service part of their installed capacity in computers and communications gear.

6. IT Security

Like freedom and democracy the word *security* has many meanings. There is physical security and logical security. Plant security (largely based on hardware) and cyber security—a so-far software intensive, elusive goal. Both can be backed up by insurance, with much more experience associated with the former rather than with the latter.

Engineering catastrophes like the one at Japan's Fukushima nuclear plants show clearly how half-baked controls can engender a false sense of security, and easily become subject to slackness and mismanagement. It was not nuclear technology, in the strict sense of the term, that failed in eastern Japan. Rather, it was an unwarranted accumulation of shortcomings, such as the lack of emergency electric power and other deficient technical "solutions," that led to the disaster.

Nuclear power stations require their own security solutions and not those meant for a hospital or a bank. Disaster containment had probably been inspected hundreds of times, but not the proper positioning and timely action of support systems. Sloppiness is made worse by caring for the implementation of engineering advances but not for their steady maintainability and upgrade—an oft-encountered shortcoming, as section 1 brought to the reader's attention.

What has been briefly stated of security measures associated with power production is true of security at large, evidently including the concept of clearly defined ownership of data, application codes, and associated processes. An integral part of this reference is the notion of a supply chain based on particular systems and conditions to provide a fast, efficient and secure interaction at an affordable cost.

Effective solutions to cyber security are urgently needed because online crime is on the rise. High-profile attacks, such as the theft of customer details at Adobe, the software company, and of customer files from the databases of major banks, highlight the extent of the threat. Intruders have become more sophisticated and their target as well as their tactics are becoming more lethal.

Among the new victims are universities and small businesses, which have so far been limited in their countermeasures. Several small and medium enterprises have been breached but did not know what had happened to them for some time. To make matters more complex nation-states have been accused of backing hackers to steal intellectual property from companies to hand to rivals registered in the country of nation-intruders. The underworld is no more limited to unlawful outfits.

Both clear definitions of data ownership and security measures to protect the data are necessary. With increasingly more business being done online, hackers can exploit plenty of opportunities. A 2013 report published by Symantec, a security firm, estimated that cybercrime costs the world $113 billion a year. Symantec put the number of victims at 378 million. Another research reckoned that in 2012 malicious attacks cost American companies $227 for each customer's or user's account put at risk.[11]

A frequent scam by intruders is to send fake emails that masquerade as coming from legitimate sources and ask a firm's clients or employees to enter their usernames and passwords. According to some estimates about a fifth of people who receive these emails are fooled by them and provide the required information. Once inside their victim's account intruders take control of it and do as they please with its contents.

Back in 2011, as smartphones and tablets started proliferating in business applications, Verizon, the telecom firm, published a report on numerous corporate data breaches that had occurred a year earlier. The Verizon study concluded that most of the security breaches were due to direct attacks on corporate servers rather than mobile devices being compromised.[12] During the intervening years, however, the pattern changed somewhat, leading several experts to predict that threats to mobile devices will grow as more and more devices are being used even if databases will remain the main concern, security-wise.

Another study, also of 2011, found there had been a steady increase in mobile *malware*—software such as viruses and *Trojan horses* designed to disrupt or steal data. One piece of malware disguised as a Google Android calendar app sent SMS messages to premium-rate numbers without the users' knowledge. Another event was a security breach that allowed unauthorized access to data held by an online storage service of cloud computing variety (sections 4 and 5). Since then, security breaches have multiplied and companies find themselves concerned at a number of thorny issues that include:

- Constraints on wireless connectivity,
- Issues about individual privacy, and
- Worries about the dependability of system solutions.

A major worry that has not yet received an appropriate answer by way of ironclad approaches is *identity theft*. It starts when intruders misappropriate someone's personal information: address, date of birth, bank account, Social Security number, and so on, to obtain fake credit cards, driver's license, and other personal items. With that information and identification in hand, criminals are free to empty the victim's account or operate under a new name.

Social Security numbers matched with other personal information enable identity thieves to apply for credit cards on the Internet, often with minimal scrutiny by issuers. A strategy followed by some identity thieves is that of using a credit card to briefly build up a solid credit history by paying off monthly bills. After some time he or she acquires the credibility needed to apply for items such as loans for cars, rental property, and more.

Matters are getting complex when we account for the fact that fraud stemming from identity theft is only a small percentage of the hundreds of billions of dollars in credit card purchases each year. Indeed, recognizing that identity theft could easily get out of hand, with assistance from the Secret Service, several of the largest American credit card issuers have built a database allowing them to share information and identify common geographic locations where credit card fraud occurs. This, however, has not solved the identity theft problem.

The restaurant, hotel, or service outlet where one hands out one's credit card for payment purposes are also security risks. Consumers accept this exposure because they believe that there is in place an infrastructure to catch people who misuse the card. This is, however, an illusion. Moreover, web users should realize that software modules are not people. One can look at the waiter and decide to trust him or not; but one does not have this feedback over the network.

Contrary to what is more or less believed, "trusted commerce" is not the order of the day even if credit cards and debit cards have become main players in the payment system. Some years ago several big banks developed the concept of *wealth cards* backed by their clients' wealth accounts as *virtual assets* including cash, stocks, bonds, derivatives, real estate, and other assets. These wealth accounts were supposed to be *transnational,* permitting their holders to have access to their wealth in any financial product, at any place and at any time.

This was supposed to be a new, much broader virtual assets and liabilities solution traded globally at any time, in any currency, anywhere in the world. Banks thought that they had done their homework with the new instrument in terms of strategic planning. They were proud to have developed a picture of how the new intermediation environment would shape up in terms of value—through way and means different from those already known. Part of the core were exotic derivatives serving the trend toward *customization*:

- For each market segment, and
- Down to the individual investor.

Promoted by high technology, the concept itself was far-reaching but it lacked security. The holder of an individual *wealth card* could pay, for instance, for the new car by instantly drawing on part of the wealth inherent in, say, a vacation house in some other country. But the wealth card concept would not fly because the security risk associated with it was enormous and very few high networth individuals wanted to employ it.

Up to a point reliability and security correlate. Able approaches are not just a question of hardware and software. The quality of the personnel put on the job is always a crucial factor as far as end results are concerned. Yet many firms continue making poor staffing assignments that harm their IT projects. Human errors are estimated to be responsible for as many as 60 percent of breaches of computer security.

Firms fail to appreciate that who becomes a part of the team is always a very important component of the whole system and of its functioning. No system is ever stronger than its weakest link.

Repeated warnings about being vigilant often go unheeded as people fail to recognize the dangers of seemingly innocuous actions such as downloading files. There are even cases where users disable security features on their computers, because security features slow things down or make the systems more complex. These issues are often overlooked when security systems are tested. In their security risk analysis IT managers have to ask themselves a number of critical queries:

- What can go wrong?
- What is the likelihood of each type of incident occurring?
- What is the impact of each operational risk?
- How can it be prevented or minimized?

At the bottom line, the essence of these queries, and of the answers provided to them, is that they help us decide on what we really *should do* as contrasted to what we are *trying* to do. They also make it possible to establish an acceptable level of security risk compared to the cost involved in its avoidance. Once we have identified all potential security risk sources and their aftermath we can set about testing for each vulnerability.

7. Hackers Have a Field Day

Understandably, security worries raise concerns about loss of control over sensitive information. The argument that cloud providers are able to devote resources to solving security issues that many customers cannot afford should only be believed by users who are ready to relegate their security responsibilities just to get rid of them.

- The cloud and its providers cannot offer, in good conscience, anything better than what current technology makes available for security reasons to everybody.
- By contrast, the cloud increases security concerns as potential security issues grow with very large scale systems, and with virtualization technologies that are still not-too-well understood (to put it mildly).

There was a time, which is by now resolutely past, when security concerns were addressed first by a data encryption standard (DES) which was 64-bit long. It was broken, replaced by a 128-bit device (which is also peanuts in security terms). Then came software-supported security, such as firewalls, but with time these became a rather banal commodity, leading firms to add security features like anti-virus and anti-spam, as well as measures to fend off distributed denial-of-service (DDoS) attacks.

There is a good reason why in late January 2014 the World Economic Forum selected data security as one of the three major themes in 2014.[13]

Service security is the twin of data security, and DDoS is the alter ego of cyber attacks, which result in the loss of confidential data or do deadly damage to intellectual property, as confused authorities, consumers, and investors do not know how to react to a surprise happening.

In mid-January 2014, Target, the US supermarket, admitted that the data of more than 70 million customers were stolen in a Thanksgiving 2013 cyber attack. This massive Target cyber theft has been one of the biggest breaches of data security in the retail sector since 2007 when TJX Companies—a discount chain that owns TJ Maxx in the US and TK Maxx in Britain—said that it had fallen victim to criminals. Retailers are a favored hunting ground for hackers seeking credit card and other personal information, while new threats involve more complex intrusions.

In May 2014 another headline news item was a cyber attack on eBay, the international online marketplace. This and the Target event made plenty of people, from executives to shoppers, more aware of the threat hackers pose to online transactions and databases. At about the same time as the Target break-in, 19 million files were stolen online from German banks while a king-size identity theft in South Korea connected to credit cards led the sovereign to issue a statement that all credit cards may be cancelled and replaced by more secure models (if and when they become available).

Statistics give no comfort. With online crime gaining momentum, according to official data, the number of companies reporting concerns about cyber security to US regulators more than doubled in 2011–2013 to 1,174. Not only commercial bankers and merchandisers but also a score of other companies, such as oil and gas outfits, have been among those most worried about cyber criminals.[14]

Cyber crime damages both business and individuals whose IDs are being manipulated by intruders. Target warned that because the theft had scared off customers, sales had declined. It also acknowledged that patrons who shopped at the retailer outside the cyber-attacks timeframe may have also been affected, as retail outfits in particular have become vulnerable.

We have come a long way from the time when, in 1849, Moltke, the Danish prime minister (not to be confused with von Moltke, the Prussian general), considered an income tax but rejected the idea as being "extremely inquisitional."[15] Privacy was supreme in the nineteenth century while in the twenty-first it is looked at as something between a hunting ground and toxic waste territory. (Personal income tax was introduced in 1813 in England to pay for the Napoleonic wars. Moltke, too, needed the money to pay for the Danish-Prussian war over Schleswig-Holstein. He ended up taking a loan from Hambros.)

Hackers have developed malware to attack software running on point-of-sale (POS) devices and create an entry to supermarket databases by way of outposts. In the Target case, the weakest link breached was the POS. The way to bet is that this will happen again as hackers are unlikely to stop at one retailer if they have discovered a successful technique.

Neither are vendors of security software immune to cyber attacks. Microsoft itself has been the victim of intruders though its market security routines (supposedly) provide an effective protection.

The events that followed one another in the US, Germany, and South Korea brought home the message that a new era may be starting in cyber insecurity where companies would feel the heat when accused of being negligent. Until recently common citizens saw a relatively limited financial impact and some companies did not even declare cyber attacks as being a material change to their business. But this is no more the case, as cloud computing provides the *malavita* with new "opportunities."

The probability of cyber crime on a company's business and its aftereffects can be ordered through a *threat curve*, which traces their likelihood and impact on a scale of increasing probability, with (usually) the most dangerous threat being the least likely. Threat curve graphics began to appear in NATO's intelligence offices in the mid-1980s, though it took more than a decade to be adopted by business and industry. The aim of these graphics has been to demonstrate the likelihood of certain dangers through an ordering permitting intelligence officers to:

- Channel a good share of resources to *probable risks*,
- Instead of concentrating on only the *worst case*, which may be quite unlikely.

In terms of IT security, this is an exercise that has merits, particularly within a globalized environment where there are many unknowns, and internal control may be spread thin failing to provide an A1 level of protection. The business implementation of a threat curve may help in revealing:

- Internal control deficiencies,
- A relative exposure to malware, and
- Unexpected weaknesses permitting security breaches.

The application of a threat curve may be extended to investigate the development and control of new IT projects where, security-wise, too-little, too-late effort is made. This situation is compound by ineffective audit programs as well as half-baked monitoring and reporting. Research in industry suggests that at least 70 percent of projects involving the implementation of new systems:

- Run into problems,
- End up delivering fewer benefits than expected, and
- Make short shrift of important issues such as security.

This is happening because too many initiatives become a sad compromise that delivers a "little more automation" rather than a truly innovative solution. The best method to overcome the deficiencies outlined in these three bullets is real collaboration between stakeholders and technologists—the only valid way for managing an ambitious, complex, and demanding IT project.

In other terms, just as critical to an IT project's success, is the way in which it is managed and how it is controlled from its initial stages to completion and final implementation. A sound practice not only demands that a rigorous structure is imposed on the development effort, but also that there are made frequent *design reviews* the outcomes of which are plotted on the threat curve in terms of vulnerabilities.

Stated in different terms, security risk analysis forms the foundation of one of the crucial aspects of information technology management. An analytical approach will document the creation of a security risk policy, its implementation, and testing. This has to be supplemented by a coherent security strategy that makes both short-term and long- term sense.

At the basic software level one of the great hopes for security/protection was Kerberos, the operational system. Kerberos, however, came and went while the security challenges remain. Most other efforts revolved around the concept that threat protection and access authentication will be enough. They are not. Hence, the move toward what could be described as "a richness of security features."

8. Security Issues Associated with Cloud Computing

Just prior to year 2000 it was thought that NASA had found the security elixir. But events proved that its computer security was so vulnerable to attack that hackers could easily disrupt command and control operations, including the tracking of orbiting spacecraft (according to a comment in a government report). The Government Accountability Office (GAO), the investigative arm of Congress, said its teams penetrated NASA systems that process and distribute scientific data and broke into NASA's most vital networks.

- The GAO picked systems at one of NASA's ten field centers by "using easily guessed passwords,"[16] and
- Its report concluded that the results of the space agency's work to improve security were exaggerated.

NASA, of course, is far from being alone in exaggerating the effectiveness of its protective measures. Industrial and commercial companies, including computer manufacturers and software firms, do the same (Intruders broke into Microsoft's well-protected database, as well as Citibank's). Neither is it a secret that in the general case:

- Data is often left un-encrypted on Web servers,
- There is no steady audit verification after transactions are done, and
- Security management by user organizations is not transparent.

Some people say that all this happened prior to cloud computing, and therefore the new environment is not responsible for it. This is an understatement because the aforementioned weaknesses continue to exist, while at the same time cloud computing increases security vulnerabilities, as section 7 has shown. Neither are these the old sort of isolated cases, hence more or less contained in terms of damage due to imperfect security. Now we are talking about millions of servers in the cloud with an unprecedented number of accesses by clients. At the core are two critical queries:

- Who owns whose information in the cloud? and
- Which party has the primary responsibility for safeguarding data in the cloud?

Theoretically the answer to the first query is the user organization. The information elements stored at the cloud provider's site are those of its clients, its employees, and its accounts. *If* so, this is a flagrant case of *absentee management* because the least that can be said is that critical information elements are not under their owner's direct watch but under somebody else's—the provider of cloud infrastructure.

This curious reversal of responsibilities (which is accompanied by absentee accountability) brings up the second critical query: Is the provider assuming legal responsibility in case of identity theft or any other act by the malavita with all damages covered? As far as the cloud infrastructure is concerned, this case has not yet been tested in court but other evidence is disquieting.

As with every complex problem, when we study security issues associated with cloud computing we should examine the profile(s) and motivation(s) of the adversary or adversaries we may confront. This calls for the establishment of priorities in terms of possible (both likely and unlikely):

- Vulnerabilities, and
- Countermeasures.

We simply cannot afford to run after all hares at the same time. If we do so, the cloud computing's security will never be improved. We have to proceed in an orderly manner by first focusing on high-impact risks, which could conceivably be realized, however slight the perceived possibility. Once this is done, we should:

- Establish for each of them the profile of the adversary, with unlikely profiles being at a premium and
- Quantify, evidently by guesstimating, the benefit an adversary derives from realizing the corresponding threat (see also the discussion on threat curves in section 7).

An adversary's potential profit may be greater or less than the cost to the cloud provider and/or its clients (the user organizations) because of intangibles that enlarge the basis that can be employed to reevaluate the probability of the attack taking place. The probability of the adversary being caught is an important guesstimate, ideally established through brainstorming till statistics become available.

Knowledge artifacts can and should play a major role in this process, not only as guards but also as intelligence collectors. The accuracy of guesstimates will be significantly improved over time after an intelligence-enriched security system goes into operation and starts learning on the job. Enriching it by hands-on experience and structuring as security engineering, it is possible to reduce security exposure by:

- Increasing the cost of an attack to the adversary,
- Improving the likelihood of the attack being detected and stopped prior to achieving its objective, and
- Decreasing the damage caused by the attack, by establishing more sophisticated and higher integrity control procedures.

The profile of the adversary must be carefully studied as it can vary significantly from "hire a hacker" from a lot of drug addicts to well-organized and richly endowed secret services of sovereign states. With the Edward Snowden revelations fears have grown that enterprise data stored on the cloud could be vulnerable to foreign surveillance. What was revealed by Snowden underscored the shortcomings of data protection laws in the time of cloud computing, where data is stored at external warehouses rather than onPremises.

Aside from the fact that the facilities of cloud computing providers may be anywhere in the global landscape and no company knows exactly where its data is at any given moment, as data flows across national borders, protecting it and regulating the security mechanism has become more complex if not an altogether impossible action. Politicians are on record for reforming the European Union's data protection rules, but this is more cosmetics for public consumption than a rigorous solution.

Many European companies share these concerns amid fears that NSA snoops could be helping to control their industrial secrets. At the same time, however, they are worried, as are their counterparts in the US, that stricter laws limiting their ability to transfer data across borders could also hinder their competitiveness—increasing the overall inefficiency rather than improving prevailing conditions.

While the majority of cloud companies are based in the US, the facilities of cloud providers with headquarters in Europe are open to all sorts of security risks. They can be even compelled by the US authorities to hand over European data if they have a subsidiary or office in the US. That happens because American law applies to all companies that conduct continuous and systematic business in the United States.

Neither will new rules alone bring Europe greater web security. Rules aside, there have to be investments in the infrastructure of the Internet and even that will be far from providing a high level of assurance. The irony is that cloud computing, which was seen by the pros as *the* solution, may become a trap. Even privacy rules that are famously tough, like the German privacy laws enshrined in the constitution and overseen by 16 different regional authorities,

- Have been softening for years due to advances in telecommunications, and
- Might get off the rails because of security risks embedded in cloud computing.

The cases we have examined in this chapter illustrate different phases of technology risk with emphasis on security exposure. There are as well other risks of a strategic and engineering nature that could damage a company's competitive standing. Business operations are negatively impacted if the firm experiences system interruptions and input errors. Operations are also hindered if the business falls behind its competitors in the information technology that it uses and the ways in which that technology is being employed. Therefore, the board and senior management must be committed to an ongoing process of upgrading, enhancing, and testing the entity's technology to effectively meet:

- Sophisticated client requirements,
- Market and regulatory changes,
- Evolving internal needs for information and knowledge, and
- A growing range of operational risks, with security being at the top of the list.

Another negative resulting from nearsighted policies is the lack of thoroughly studied security plans, most particularly plans about what to do in emergencies: from misused IDs and external viruses to deficient internal controls and power failures facilitating security breaches. Study after study on security issues documents that three out of four companies that have suffered a serious security breach had no contingency plan in place to deal with it. Therefore, when examining information security, one of the first queries posed by the IT auditor should relate to the formally defined rules regarding management of information security.

To be successful in attaining its goals the auditing of IT security must follow a broad perspective. After having established the framework, a systematic approach to security analysis would trace the problem to its origins and to subsequent developments keeping in mind that for a number of reasons, including cloud computing, cyber crime can be expected to increase in the years to come.

The absence of *will* and *skill* to be in charge of technology is highly damaging. While *security risk* and *information technology risk* are not the same, the one affects the other in several ways: the absence of an integrated security solution impacts the dependability of information services negatively, while information technology, used in an intelligent manner, can significantly improve system security. Like any other man-made system, the cyber world is man's doing, not something done to him.

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Notes

Preface

1. *The Economist*, March 15, 2014.

1 Ethical Values, Efficiency, and Effectiveness

1. Apollinaria Souslova, *Mes Années d'Intimité avec Dostoievski* (Paris: Gallimard, 1995).
2. *Daily Telegraph*, May 26, 2012. The study was done for the journal *Psychological Science*. The researchers sent a questionnaire to 5,964 psychologists; 2,155 replied.
3. *Financial Times*, November 18, 2013.
4. Jacques Attali, *Sir Siegmund G. Warburg. Un Homme d'Influence* (Paris: Fayard, 1985).
5. As a French saying has it, common sense is universally distributed; that's why each one of us has so little.
6. *Bloomberg News*, September 24, 2012.
7. *L'Expansion,* November 2013.
8. Attali, *Sir Siegmund G. Warburg.*
9. *The Economist*, October 5, 2013.
10. *Financial Times*, February 7, 2013. Barofsky is former special inspector-general of the Troubled Asset Relief Program and currently senior fellow at NYU School of Law.
11. W. K. C. Guthrie, *The Greek Philosophers: From Thales to Aristotle* (London: Methuen, 1950).
12. The term's origin is the Latin word "effectivus," which means creative or productive.
13. *Financial Times*, November 21, 2013.
14. *The Economist*, April 16, 2011.
15. *The Economist*, February 16, 2013.
16. *Financial Times*, November 18, 2013.
17. *Financial Times*, April 16, 2012.
18. Ibid.
19. *Financial Times*, September 11, 2012.

20. *Financial Times*, April 23, 2014.
21. *Financial Times*, April 8, 2013.
22. The others were Sly Bailey from *Trinity Mirror* and David Brennan from AstraZeneca.
23. *Financial Times*, May 9, 2012.
24. *The Economist*, July 31, 2010.
25. Ibid.
26. *International Herald Tribune*, December 14, 2009.
27. *Bloomberg News*, February 7, 2011.
28. *Financial Times*, January 6, 2012.
29. *Financial Times*, January 9, 2012.
30. *Financial Times*, April 16, 2012.
31. Interestingly enough this represented more than three-fourths of the taxpayer money the Bush administration contributed, in a rescue frenzy, to Citigroup's coffers.

2 Senior Managers Are in the Frontline of Efficiency and Ethics

1. *BusinessWeek*, April 1, 2002.
2. That decision concerned taking over Opel, GM's subsidiary, heavily damaged by Allied bombing during World War II.
3. Margaret Heffernan, *Willful Blindness: Why We Ignore the Obvious at Our Peril* (London: Simon & Schuster, 2011).
4. "I am the president."
5. *The Economist*, May 8, 2010.
6. *The Economist*, May 28, 2011.
7. D. N. Chorafas, *Operational Risk Control with Basel II: Basic Principles and Capital Requirements* (London and Boston: Butterworth-Heinemann, 2004).
8. *USA Today*, August 2, 2002.
9. *Fortune*, June 24, 2002.
10. *Sovietskaya Kultura*, May 21, 1988. The Kapitsa letter was written in support of a Soviet pardon for Andrei Sakharov and Yuri Orlov. Andropov rejected it, but seems to have changed his mind when sometime later he became the Soviet Union's boss.
11. *Financial Times*, June 26–27, 2010.
12. Oriana Bandera, Luigi Guiso, Andrea Prat and Raffaella Sadun, *What Do VCEOs Do?* Harvard Business School Working Paper 11–081.
13. President of California-based Pacific Institute research group.
14. *Financial Times*, February 12, 2012.
15. *The Economist*, March 15, 2014.
16. *The Economist*, October 29, 2011.
17. *BusinessWeek*, December 8, 2004.
18. *The Economist*, April 28, 2012.
19. *Time Magazine*, May 6, 2002.
20. *EIR*, April 12, 2002.

21. *Financial Times*, June 6, 2014.
22. Heffernan, *Willful Blindness*.
23. *BusinessWeek*, November 22, 1993.
24. *BusinessWeek*, April 24, 1995.
25. June 15, 2002.
26. Edward I. Koch, *Mayor: An Autobiography* (New York: Simon and Schuster, 1984).
27. *Fortune*, June 26, 2002.

3 Social Ethics and Rising Corruption

1. D. N. Chorafas, *Public Debt Dynamics in Europe and the US* (New York and London: Elsevier Insights, 2014).
2. D. N. Chorafas, *The Changing Role of Central Banks* (New York: Palgrave Macmillan, 2013).
3. *Bloomberg News*, May 11, 2012.
4. *Financial Times*, November 29, 2013.
5. While for their part the illegal immigrants get everything for free.
6. *Financial Times*, November 21, 2013.
7. *Le Canard Enchainé*, July 24, 2013.
8. *The Economist*, October 29, 2011.
9. Ibid.
10. *The Economist*, February 4, 2012.
11. *The Economist*, October 29, 2011. According to World Bank findings there were 102 corrupt companies incorporated in the US, 28 in Lichtenstein, 27 in the Bahamas, 24 in Hong Kong, and another 24 in Britain, but only 7 in Switzerland.
12. *The Economist*, June 25, 2011.
13. Ibid.
14. *Financial Times*, July 26, 2013.
15. *USA Today*, June 6, 2008.
16. New SEC rules designed to enforce such access for shareholders were defeated in court in 2013 by the US Chamber of Commerce. Subsequent to this, the SEC has allowed individual shareholders to press for proxy access at a company by company level.
17. *Financial Times*, November 22, 2013.
18. Ibid.
19. Credit Suisse, *Research Monthly Switzerland*, February 28, 2012.
20. *The Economist*, January 5, 2013.
21. *The Economist*, May 26, 2012.

4 Ethics and Efficiency in Public Administration

1. *The Economist*, August 20, 2011.
2. *The Economist*, November 28, 2013.

3. Kiran Moodley, "The Euro Was Made for Germany: Ex Spanish PM," CNBC, http://www.cnbc.com/id/101228031, November 26, 2013.
4. *Bloomberg Businessweek*, September 24–30, 2012.
5. *Financial Times*, November 26, 2013.
6. *The Economist*, November 23, 2013.
7. Sky News, October 20, 2010.
8. *Financial Times*, November 14, 2013
9. Ireland's case is different. Its economic troubles are due to a runaway banking industry, not due to chronic profligate government policies.
10. A term coined by a French journalist in the early 1960s along with the term "Third World."
11. This evidently applies to Pakistan, but because of its derelict state it has been left out of this discussion.
12. D. N. Chorafas, *Public Debt Dynamics in Europe and the US* (New York and London: Elsevier Insights, 2014).
13. UBS, CIO Monthly Letter, Wealth Management, December 2013.
14. Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds*. Originally published in the eighteenth century, reprinted in Britain by Amazon.com in 2013.
15. *The Economist*, January 28, 2012.

5 Be Ready for the "Unthinkable"

1. Bank of America Merrill Lynch, *Global Energy Weekly*, April 19, 2011.
2. The British to finance the war and Napoleon to provide cannon feed for the war against Britain and against everyone else in the European continent.
3. D. N. Chorafas, *Basel III, the Devil and Global Banking* (London: Palgrave Macmillan, 2012).
4. Nathan Miller, *F.D.R.: An Intimate History* (New York: New American Library, 1983).
5. It is wise to distinguish between *commercial paper* backed up by a commercial transaction and all other debt and IOY instruments, which are financial paper.
6. Not to be confused with the first major banking crisis of the Greco-Roman world that took place much later under Tiberius.
7. Anthony Everitt, *Cicero: A Turbulent Life* (London: John Murray, 2001).
8. Ian Davidson, *Voltaire in Exile* (London: Atlantic Books, 2004).
9. Irvin Unger and Debi Unger, *The Guggenheims: A Family History* (New York: HarperCollins, 2005).
10. D. N. Chorafas, *Science and Technology* (Springer Verlag, Cham, Heidelberg, New York, London, 2015).
11. In my research I have found that the divisor of notional principal in times of crisis to replacement value varies between 5 and 6. See D. N. Chorafas, *Alternative Investments and the Mismanagement of Risk* (London: Palgrave Macmillan, 2003) and D. N. Chorafas, *Credit Derivatives and the Management of Risk* (New York: New York Institute of Finance, 2000).

12. Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon, 2010).
13. Miller, *F.D.R.*
14. Georges Pompidou, *Le Noeud Gordien* (Paris : Plon, 1974).
15. Eric Hobsbawm, *Age of Extremes: 1914–1991* (London: Abacus/Little Brown, 1995).
16. Ibid.
17. Miller, *F.D.R.*
18. Not all of Roosevelt's government-sponsored initiatives and agencies were successful. The NRA lingered in limbo for some time until the Supreme Court held it unconstitutional. The AAA, too, received a black eye from which it never recovered.
19. Put to rest by Bill Clinton, the Democratic president, just before leaving office.
20. *Financial Times*, September 30, 2010.
21. On March 7, 2011, Moody's downgraded the Greek debt to B+ from Ba+, a drop of three notches in the credit rating scale.
22. *The Economist*, February 25, 2010.
23. The other 40 percent is discretionary spending including defense.
24. *Bloomberg News*, March 9, 2011
25. UBS CIO WM, June 5, 2014.
26. *Financial Times*, June 6, 2014.
27. *Le Canard Enchainé*, April 15, 2009.
28. *The Economist*, January 29, 2011.
29. *Financial Times*, March 25, 2014.

6 Ethics and Efficiency in the Financial Industry

1. Sterling Seagrave, *Lords of the Rim* (London: Corgi Books, 1995).
2. *The Economist*, December 31, 2011.
3. William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (New York: Simon & Schuster, 1989).
4. D. N. Chorafas, *Basel III, the Devil, and Global Banking* (London: Palgrave Macmillan, 2012).
5. D. N. Chorafas, *Stress Testing for Risk Control Under Basel II* (Oxford and Boston: Elsevier, 2007).
6. *The Economist*, October 29, 2011.
7. Goodwin joined a list of ex-Sirs that includes Anthony Blunt, a Soviet spy, and Robert Mugabe, the political manipulator and president of Zimbabwe.
8. CNN, February 23, 2012.
9. Calvi and Sindona worked together toward the end of their life, and both fell on their swords.
10. D. N. Chorafas, *Financial Boom and Gloom: The Credit and Banking Crisis of 2007–2009 and Beyond* (London: Palgrave Macmillan, 2009).

11. *Financial Times*, January 11, 2013.
12. Which are generally rebaptized shaky liabilities.
13. Chorafas. *Financial Boom and Gloom*.
14. *Financial Times*, November 29, 2013.
15. Chorafas, *Financial Boom and Gloom*.
16. *Financial Times*, April 26, 2012.
17. "Independent"? *Financial Times*, June 6, 2014.
18. Adam Hochschild, *King Leopold's Ghost: A Story of Greed, Terror and Heroism in Colonial Africa* (London: Pan Books, 2006).
19. *The Economist*, November 5, 2011.

7 Libor Scandal, Derivatives, Gold Deceits, and the ETFs

1. This fine has been a joint decision by Britain's Financial Services Authority (FSA) and US Commodity Futures Trading Commission (CFTC).
2. Rosa Abrantes-Metz of NYU's Stern School of Business was one of the academics who, in 2009, raised the alarm that something fishy was going on with Libor.
3. *Bloomberg News*, June 29, 2012.
4. Once described by Lord Mandelson, then British government's business secretary, as "the unacceptable face of banking" (*The Economist*, July 7, 2012).
5. *Financial Times*, July 6, 2012.
6. *Bloomberg News*, July 16, 2013.
7. *Financial Times*, June 30–July 1, 2012.
8. "The reference to Euribor is completely useless for Italian banks," says Giovanni Sabatini, the managing director of the Italian Banking Association. "Euribor is less than 1% and our banks are paying 350–400 basis points above Euribor" (*The Economist*, July 14, 2012).
9. *Financial Times*, December 19, 2012.
10. *Financial Times*, September 11, 2012.
11. *Financial Times*, February 8, 2013.
12. *Financial Times*, January 11, 2013.
13. Société Générale and Crédit Agricole were drawn into the benchmark-rigging scandal when the *Financial Times* reported that employees at the banks communicated with a Barclays euro swaps trader who formerly worked at SocGen (*Financial Times*, November 18, 2013).
14. *The Economist*, July 2, 2012.
15. *Financial Times*, July 6, 2012.
16. Ibid.
17. *The Economist*, February 26, 2011.
18. D. N. Chorafas, *Banks, Bankers, and Bankruptcies under Crisis: Understanding Failures and Mergers during the Great Recession* (New York: Palgrave Macmillan, 2014).
19. *Financial Times*, December 13, 2013.
20. *Financial Times*, February 24, 2014.

21. It should be remembered that Nixon ended the dollar's convertibility into gold at the request of governments, under pressure by the US military, because the gold reserves were getting depleted. This 1971 decision put to rest the Bretton Woods agreement.
22. *Business Week*, April 14, 1997.
23. To appreciate what goes on in the mind of speculators who see dollars *now* one has to remember that the magnitude of the gold carry trade has reached levels equivalent of four to five years of total world gold mine output.

8 The Strategy of Financial Gambling

1. Since 2000 the CFTC allowed brokers to invest customer funds in various assets, including corporate notes, foreign sovereign debt, and money-market funds, including the "borrowing" of customer funds for a short period to buy securities.
2. *Financial Times*, June 26, 2013.
3. *International Herald Tribune*, December 14, 2011.
4. This is a French saying dating back to the late nineteenth century when cities were employing low-paid persons to light the gas lamps in the streets. These were called *lampistes* and they did not always do things right—but the mayor and his fat cats never took responsibility when there was an accident.
5. *Financial Times*, February 3, 2012.
6. *Financial Times*, November 2, 2011.
7. *Bloomberg News*, November 18, 2013.
8. *Financial Times*, November 3, 2011.
9. *Le Canard Enchainé*, July 24, 2013. Other estimates bring that amount up to €90 billion ($121.5 billion).
10. Precision Capital is a bank holding company incorporated in Luxembourg and owned by the Al Thani family of Qatar.
11. *Financial Times*, November 26, 2013.
12. Deutsche Bundesbank, *Financial Stability Review 2013*, Frankfurt.
13. Bank of America Merrill Lynch, November 19, 2013.
14. *Business Week*, August 7, 2000.
15. *Financial Times*, August 16, 2012.
16. *Financial Times*, August 9, 2012.
17. Ibid.
18. The US had set up the U-Turn mechanism to allow that operations to continue even while there were sanctions in place on Iran.
19. *The Economist*, August 11, 2012.
20. *Financial Times*, August 9, 2012.
21. *Financial Times*, August 16, 2012.
22. Originally known as Prudential Bache as Prudential, the US insurance company, took over Bache after the broker teetered in the aftermath of trying to corner the silver market with the Hunt brothers.
23. *Business Week*, November 19, 1990.
24. *International Herald Tribune*, August 20, 1999.

9 Barings: The Crashing of a Venerable Bank

1. Joseph Wechsberg, *The Merchant Bankers* (London: Weidenfeld and Nicolson, 1967).
2. Ibid.
3. Ibid.
4. John Clapham, *The Bank of England: A History, 1694–1914*, Vol. 2 (Cambridge: Cambridge University Press, 1945).
5. Judith H. Rawnsley, *Total Risk: Nick Leeson and the Fall of Barings Bank* (New York: Harper Business, 1995).
6. *Sunday Times*, February 26, 1995.
7. *Financial Times*, July 19, 1995.
8. *The Wall Street Journal*, Asian edition, September 11, 1995.
9. Ibid.
10. *Financial Times*, September 20, 1996.
11. *The Straits Times*, May 26, 1995.
12. In the meantime, the building by the Singapore river where Barings used to be became a historical monument with tourists flocking to take a look at it. The same is true of the bar in which Nick Leeson used to spend some of his earnings.
13. Osaka Securities Exchange.

10 Parmalat: The Hedge Fund with Dairy Products on the Side

1. *The Economist*, January 17, 2004.
2. Ibid.
3. *The Economist*, December 20, 2003.
4. *BusinessWeek*, January 26, 2004.
5. Ibid.
6. *Bloomberg News*, December 30, 2003. This was a temporary detention. In the end Calisto Tanzi escaped prison supposedly because of his age.
7. *Financial Times*, December 30, 2003.
8. *The Economist*, January 17, 2004.
9. Ibid.
10. See also in chapter 6 Ivar Kreuger's choice of the US capital market as his financier.
11. *EIR*, January 16, 2004.
12. Ibid.
13. D. N. Chorafas, *Financial Boom and Gloom: The Credit and Banking Crisis of 2007–2009 and Beyond* (London: Palgrave Macmillan, 2009).
14. *The Economist*, February 7, 2004.
15. *Financial Times*, February 14–15, 2004.
16. *EIR*, February 20, 2004.
17. *The Economist*, January 11, 2014.
18. When its GDP was rising faster than that of Britain.

11 Ethics and Efficiency in Manufacturing and Services

1. *Financial Times*, September 21, 2012.
2. *Financial Times*, January 6, 2014.
3. *The Wall Street Journal*, November 21, 2012.
4. Bank of America Merrill Lynch, *Hewlett-Packard*, February 6, 2013.
5. Peugeot promised it would not pay dividends, buy back shares, or award stock options as a condition of the rescue.
6. *Financial Times*, July 12, 2013.
7. In Italy, Fiat has been sending workers home to collect a special state benefit rather than sacking them.
8. For the share by Veba, a union medical retirement trust that owned the 41.5 percent of Chrysler not already acquired by Fiat.
9. Bank of America Merrill Lynch, *Fiat SpA*, May 2013. Ratios prior to the purchase by Fiat of the United Autoworkers share of Chrysler, but reflecting its likely effect.
10. Chrysler's previous association with a European carmaker was an ill-fated takeover by Daimler in 1998. That ended nine years later when the exasperated Germans sold it to a private equity firm.
11. *The Economist*, July 27, 2013.
12. In the event of a default, the insurer promises to replicate the coupons and payment at maturity of the bond.
13. Bank of America Merrill Lynch, *RIC—Monthly Investment Review*, August 13, 2013.
14. *The Economist*, July 27, 2013.
15. By contrast, bonds issued by the state governments, as distinct from the municipalities they constitutionally control, are not subject to federal bankruptcy courts.
16. Which recently absorbed US Airways. Notice that US Airways, Delta, and United Airlines sought Chapter 11 protection over the past decades as they confronted both unsustainably high labor costs and, for some, an inordinate amount of aircraft leasing costs.
17. *Financial Times*, November 20, 2012.

12 Ethics, Opportunities, and Risks with Information Technology

1. *Financial Times*, June 27, 2012.
2. *Financial Times*, July 26, 2012.
3. *Bloomberg News*, January 29, 2014.
4. Bank of America Merrill Lynch, *The RIC Report*, November 12, 2013.
5. Focusing on patterns of phone numbers, location(s), and length of calls rather than contents.
6. *The Economist*, January 4, 2014.
7. *The Economist*, January 11, 2014.

8. *Bloomberg News*, February 4, 2014.
9. Etymologically, the terms *onDemand* and *onPremises* can be used not only for software and different types of services but also for infrastructure. It has been a deliberate choice in this text to employ these two words strictly in connection with programming products on the cloud, as the developing general practice warrants, but the terms are much more generic.
10. Bank of America Merrill Lynch, *European Software*, October 22, 2013.
11. *The Economist*, February 22, 2014.
12. *The Economist*, October 8, 2011.
13. The other two top themes of 2014 have been the world's rapidly growing population and the building of a sustainable educational system around the globe.
14. *Financial Times*, June 6, 2014.
15. Joseph Wechsberg, *The Merchant Bankers* (London: Weidenfeld and Nicolson, 1967).
16. Communications of the ACM, Vol. 42, No. 7, July 1999.

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