

# Management Risk

*Economic Capital Allocation with Basel II Operational Risk Control with Basel II  
1998–2004*

*Alternative Investments and the Mismanagement of Risk*

*Stress Testing: Risk Management Strategies for Extreme Events*

*Outsourcing, Insourcing and IT for Enterprise Management*

*Liabilities, Liquidity and Cash Management: Balancing Financial Risk*

*The Management of Philanthropy in the Twenty-first Century*

*Enterprise Architecture and New Generation Information Systems*

*Modelling the Survival of Financial and Industrial Enterprises: Advantages, Challenges, and Problems with the Internal Rating-Based (IRB) Method*

*Managing Operational Risk: Risk Reduction Strategies for Investment Banks and Commercial Banks*

*Managing Risk in the New Economy*

*Implementing and Auditing the Internal Control System*

*Integrating ERP, Supply Chain Management, and Smart Materials*

*Internet Supply Chain: Its Impact on Accounting and Logistics*

*Reliable Financial Reporting and Internal Control: A Global Implementation Guide*

*New Regulation of the Financial Industry*

*Managing Credit Risk, Volume 1, Analyzing, Rating and Pricing the Probability of Default*

*Managing Credit Risk, Volume 2, The Lessons of VAR Failures and Imprudent Exposure*

*Credit Derivatives and the Management of Risk*

*Setting Limits for Market Risk*

*Commercial Banking Handbook*

*Understanding Volatility and Liquidity in Financial Markets*

*The Market Risk Amendment: Understanding Marking to Model and Value-at-Risk*

*Cost-Effective IT Solutions for Financial Services*

*Transaction Management: Managing Complex Transactions and Sharing Distributed Databases*

# Management Risk

**The Bottleneck is at the Top of the Bottle**

Dimitris N. Chorafas



© Dimitris N. Chorafas 2004

Softcover reprint of the hardcover 1st edition 2004 978-1-4039-2143-7

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No paragraph of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, 90 Tottenham Court Road, London W1T 4LP.

Any person who does any unauthorized act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The author has asserted his right to be identified as the author of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published 2004 by  
PALGRAVE MACMILLAN  
Houndmills, Basingstoke, Hampshire RG21 6XS and  
175 Fifth Avenue, New York, N.Y. 10010  
Companies and representatives throughout the world

PALGRAVE MACMILLAN is the global academic imprint of the Palgrave Macmillan division of St. Martin's Press, LLC and of Palgrave Macmillan Ltd. Macmillan® is a registered trademark in the United States, United Kingdom and other countries. Palgrave is a registered trademark in the European Union and other countries.

ISBN 978-1-349-51537-0 ISBN 978-1-4039-4810-6 (eBook)  
DOI 10.1057/9781403948106

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data  
Chorafas, Dimitris N.

Management risk: the bottleneck is at the top of the bottle/Dimitris N. Chorafas.  
p. cm.

Includes bibliographical references and index.

1. Risk management – United States. 2. Finance. 3. Business ethics – United States.  
4. Executives – United States – Conduct of life. 5. Risk management – Europe.  
6. Business ethics – Europe. 7. Executives – Europe – Conduct of life. I. Title.

HD61.C546 2004

658.15'5–dc21

2003056341

10 9 8 7 6 5 4 3 2 1  
13 12 11 10 09 08 07 06 05 04

# Contents

<i>List of Figures and Tables</i>	viii
<i>Preface</i>	ix
<i>Acknowledgments</i>	xiii

## **Part I Management's Responsibility Towards the Shareholders**

<b>1 Senior Management Ethics and Personal Accountability</b>	<b>3</b>
1 Introduction	3
2 "Irrational exuberance" and "infectious greed"	5
3 Stress testing and market confidence	8
4 The sense of a bubble	11
5 Cheer-leaders, equity traders, and true professionals	14
6 What differentiates us from our competitors?	17
7 Market confidence and the US Corporate Responsibility Bill	19
<b>2 Mismanagement and the Firing of a Bad CEO</b>	<b>24</b>
1 Introduction	24
2 Many of today's CEOs lack crisis experience	25
3 Mismanagement at AT&T	28
4 Beyond mismanagement: Enron, WorldCom, Qwest Communications, J.S. Sainsbury, and WPP	31
5 BCCI	34
6 Shareholders kick out poorly performing CEOs	35
7 Charismatic and honest business leaders	37
<b>3 Creative Accounting, EBITDA, and Core Earnings</b>	<b>40</b>
1 Introduction	40
2 Rethinking the reliability of accounting	41
3 Understanding creative accounting	44
4 Management ethics and financial disclosures	46
5 Income statement, proforma, and EBITDA	49
6 Standard & Poor's core earnings	53
7 Prerequisites for forward-looking statements	55
<b>4 The Misleading of Investors</b>	<b>58</b>
1 Introduction	58
2 Efficient market theory and the facts of real markets	59

3	The contribution of financial analysts	62
4	Investors must learn to manage their assets and liabilities	65
5	The New York Attorney General and the SEC	68
6	Learning from Mediobanca and Dr. Cuccia	71
7	Overexposure and reputational risk	75
<b>5</b>	<b>Top Management Pay and Options</b>	<b>78</b>
1	Introduction	78
2	“Never have so many been paid so much for doing so little”	79
3	Unwarranted executive compensation	83
4	Executive mega-options	86
5	Why options can lead to trouble	89
6	Compensation Committees and executive bonuses	92
<b>6</b>	<b>Responsibilities of Certified Public Accountants and of the Board</b>	<b>95</b>
1	Introduction	95
2	A history of audit miscarriages	96
3	Did Arthur Andersen ring the alarm bells about Enron?	99
4	Audit Committees and the choice of auditors	102
5	External auditors’ responsibilities and the cost of settlements	104
6	Audit reform, the auditors, and the board	107
7	The evolution of regulatory legislation	110
<b>Part II</b>	<b>A Highly Leveraged Company, its Trades, its Accounts, and its Banks</b>	
<b>7</b>	<b>Enron: The End of an Empire</b>	<b>115</b>
1	Introduction	115
2	Enron’s deals	116
3	Enron’s overexposure	119
4	Enron and LTCM	122
5	Lessons from Enron’s bankruptcy	125
6	The limits of creative accounting	127
7	Chapter 11 and prepackaged bankruptcies	130
<b>8</b>	<b>Assigning the Blame for the Enron D��b��cle</b>	<b>134</b>
1	Introduction	134
2	The Commodity Modernization Act	135
3	Deregulation	138
4	Consultancies, the media, and class actions	141
5	Lessons from Enron’s failed broadband venture	143
6	Enron, EES, and outsourcing	146
7	Enron and emerging markets	149

<b>9</b>	<b>The Bankers of Enron</b>	<b>151</b>
1	Introduction	151
2	Enron, its bankers, and its investors	152
3	The aftershocks at Enron's banks	155
4	Prepays, J.P. Morgan Chase, and surety bonds	159
5	Merrill Lynch, LJM2, and the Nigerian barges	162
6	Enron and the weather derivatives market	165
7	Banks and bad debts	167
<b>10</b>	<b>Trading and the Risks of Derivatives Exposure</b>	<b>171</b>
1	Introduction	171
2.	The leverage obtainable with derivative financial instruments	173
3.	Enron's use of energy swaps	176
4.	J.P. Morgan Chase's derivatives exposure	177
5	Derivatives, Fannie Mae, AIG, and Enron	180
6.	Derivatives and the deregulation of financial institutions	184
7.	Ponzi games can have derivatives	188
<b>11</b>	<b>Investors, the Securitization of Bad Loans, and the Probability of Default</b>	<b>192</b>
1	Introduction	192
2	Capital markets defined	193
3	The evolution of credit insurance	194
4	The role played by securitization	197
5	Securitization of doubtful loans and moral hazard	202
6	Studying the probability of default	204
7	What is meant by an "asset-light strategy"?	208
8	SPVs and overleveraging	210
 <b>Part III Problems don't Disappear because they are Ignored</b>		
<b>12</b>	<b>Case Studies of Banks which are Finding the Going Tough</b>	<b>215</b>
1	Introduction	215
2	Who was to blame for the losses at Allied Irish Bank?	216
3	Commissions have damaged Allied Irish Bank	218
4	Red ink at American Express	221
5	Unilever and others v. Merrill Lynch Investment Managers	224
6	Crédit Lyonnais and Executive Life Insurance	226
7	Deutsche Bank and Bankers Trust	228
	<i>Notes</i>	232
	<i>Index</i>	238

# List of Figures and Tables

## Figures

1.1	Market dynamics change the business frame of reference	4
1.2	Accounting scandals and the dollar, January 1–June 30, 2002	10
1.3	WorldCom: one-year trend in share price and bond spread over US Treasuries, June 2001–June 2002	18
3.1	The growing importance of financial assets in a modern economy, 1991–2001	52
4.1	Capital depletion among insurers	76
7.1	Enron pays the price for its high leverage and accumulated risks, 1999–2001	116
10.1	While US manufacturing falls, derivatives soar, 2000–2	172
10.2	Allocation of leveraged capital among different investment channels, 2002	173
10.3	Derivatives exposure soars at US commercial banks, 1990–2003	182
10.4	The distribution pattern of derivatives trades, with the US in the lead	187
11.1	The credit insurer as a meta-layer in the seller–buyer nexus	195
11.2	US cumulative offering of securities backed by auto loans, credit-card receivables, and computer leases, 1985–7	198
11.3	Asset-backed securities, US and Europe, 1991–2001	199
11.4	Global turnover data on secondary loan trading, 1991–2001	201
11.5	Financing of the non-financial sectors, excluding financial derivatives and other accounts payable, 1995–2001	206

## Tables

2.1	Cumulative statistics on tenure of CEOs, 2002	26
5.1	Top dozen US highest-paid CEOs, 1990	81
5.2	Decreasing the stockholder's profits, 2001	87
5.3	Increasing the stockholder's losses to reward inefficiency, 2001	87
9.1	The biggest creditors who lost from Enron's bankruptcy	152
9.2	The April 28, 2003 settlement with Wall Street firms	157
11.1	The decline of bank lending, 1980s–1990s	204
11.2	Likelihood of failure for rated companies	207

# Preface

Based on an extensive research project in the US, UK, and continental Europe, this book has been written for both professionals and the academic market, particularly senior-level and graduate studies in Business Administration and Management. In the professional market, the book addresses practitioners in business and industry: manufacturing companies, merchandising firms, commercial banks, securities houses, service companies, and consultancies. It is designed for people interested in the benefits provided by sound management, as well as the avoidance of malpractices which lead to investors being misled by the companies' senior management, financial analysts, and public accountants.

The information resulting from this research will be vital to members of the board, chief executive officers (CEOs), chief operating officers (COOs), financial directors, members of Audit Committees, auditors (both internal and external), and lawyers (corporate and partners of law firms), institutional investors, investment advisors, financial analysts, operations managers, consultants, and regulators.

The text outlines the reasons why *management risk* must be examined within the perspective of each company's business challenges. Research results suggest there is a synergy between shareholder value and business ethics. Senior executives who participated in the research and during the meetings underlined:

- Senior management's accountability not only for financial results but also for *reliable financial reporting*
- The benefits as well as the risks associated with *value differentiation* through novel strategic policies
- The reasons why *honesty is the best policy* at the level of the board, the CEO, and senior management
- The risks associated with *near-sighted management*, skills obsolescence, overcentralization, and dubious deals.

Among the critical questions this book addresses are: What can be learned from Enron, Global Crossing, Tyco International, WorldCom, Allied Irish Banks (AIB), the American International Group (AIG), American Express, Merrill Lynch, J.P. Morgan Chase, and a great number of other companies. Was management skill really lacking, or was it that management attention was absent because the board, the CEO, and senior executives had spread themselves too thin dealing with diverse and uncorrelated issues?

Management risk has many origins, and lack of management attention is a central one. As the complexity of business increases, one of the scarcest

commodities becomes the time and attention of senior management. Very few business leaders are able to cope with troubles on many fronts. Globalization, innovation, technology, new sophistication of financial instruments, the flood of information, and the amount of risk being assumed has changed the nature of crisis management. Much more powerful tools – and a new code of ethics – are needed to cope with simultaneous fights on several fronts.

\* \* \*

In practically every Group of Ten (G-10) country, and in many others, in the 2000–3 timeframe, the banking system had to contend not only with a deteriorating overall economic situation but also with a persisting bear market on the stock exchanges and substantial loan losses. This caused credit institutions to set up risk provisions in their balance sheets, while insurance companies found themselves obliged to liquidate equities in their portfolios. Although it cannot be inferred from this situation that banks, insurance firms, and other companies had acute liquidity or solvency problems, financial and industrial firms throughout the G-10 landscape and elsewhere have been confronted with serious profitability issues. The better-managed entities took measures to cut costs and reduce their risk exposure, but few used a really sharp knife to cut the salaries of their senior executives, or significantly reduce their stock options.

Whether in cash or through options, *overpay* is one of the manifestations of management risk. The same is true of any remuneration, beyond a basic salary, not related to performance. Overpay has another major negative – inciting senior management to take inordinate risk, and use a high level of leverage, to get a bigger bonus. France Télécom is a prime example. After privatization, its top brass ran up a debt of Euro 70 billion, outstripping the gross domestic product (GDP) of every African country except Egypt and South Africa. The French taxpayers had to pick up more than half of the bill, since the French government owned 56.5 percent of France Télécom.

Mismanagement is a glaring example of management risk, and so is malfeasance. On February 25, 2003, four former Qwest Communications executives were indicted by a grand jury in Denver, CO, on criminal charges stemming from an alleged accounting fraud that investigators said had improperly boosted the US telecom group's revenues. The Securities and Exchange Commission (SEC) also filed a civil complaint against eight executives at Qwest Communications, claiming that they had manipulated another contract to inflate revenues by \$100 million. John Ashcroft, the US Attorney General, characterized the investigation of the telecoms group as "active and on-going," suggesting that additional action might follow.

In the 2001–3 timeframe, with Enron, Global Crossing, Adelphia Communications, WorldCom, Tyco and many other well-known companies

either going bankrupt or facing serious legal troubles, the SEC, Department of Justice, and Attorney Generals of several states had their hands full. On April 28, 2003, announcing a settlement with ten major Wall Street firms, William Donaldson, the Chairman of SEC, said that he was profoundly saddened and angry, about the conduct alleged in the SEC complaints, adding that: "There is absolutely no place for it in our markets, and it cannot be tolerated."

Heavy penalties, "disgorgement" of fraudulently acquired profits, and the like, are manifestations of management risk. Nor was the nearly \$1.4 billion settlement the end of the worries of banks involved in the malpractice referred to in the preceding paragraph. More red ink may still run as, after having settled with the Attorney General and the regulators, Wall Street firms can now expect plaintiff lawyers to start civil suits, including class actions. Eliot Spitzer, the Attorney General of New York State, who brought the charges, remarked during the settlement that malfeasance went well up the corporate food chain. While the CEOs of the financial institutions which reached the settlement may have been spared personal indictment, legal proceedings in the future may well cover further aspects of malfeasance. All entities should therefore get serious about the legal implications of management risk.

\* \* \*

The twelve chapters of this book have been divided into two parts. Part I examines senior management's responsibility towards their shareholders. Starting on a positive tone, Chapter 1 draws the reader's attention to the correlation between management ethics and personal accountability.

Chapter 2 presents the opposite perspective: what constitutes the background of mismanagement and how difficult it is to get rid of a bad CEO whose actions damage the company. Chapter 3 explains some of the means that have been employed to mislead investors, other stakeholders, and regulators. Creative accounting and Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) are the two key issues here.

The damage to investors from financial analysts and others who should have been reliable in their reporting is the theme of Chapter 4. Many of their fraudulent acts led to reputational risk. While the abuse of management pay and executive options is not yet a criminal act, Chapter 5 demonstrates that as this practice spreads and increases in magnitude, legislators and regulators may have to act to bring it under control.

Chapter 6 completes Part I by focusing on the responsibilities of certified public accountants (CPAs, chartered accountants) and of the board of directors. The text presents the reader with a history of audit miscarriages, and concludes with the evolution of legislation regarding financial malfeasance. A basic principle in business is: "if you have nothing to hide, don't hide anything."

The six chapters of Part II concentrate on case studies of highly leveraged companies, their rapid ascent to stardom, and their equally swift crash. Chapter 7 starts with the deals done at Enron which eventually brought down the company, its shareholders, and its employees – but not its senior management, which was pulled out of the wreckage relatively unscathed. The blame for Enron's débâcle does not fall on one single person but on several, as Chapter 8 suggests. Enron's superleveraging started soon after the Commodities Future Modernization Act, on which its top brass capitalized to gear the company sky-high. Then came kickbacks and forays into non-core business, like broadband, which became financially disastrous. Enron was helped by its bankers in superleveraging itself, as well as in some other deals which were on the borderline of legality, as Chapter 9 suggests. Beefing up the value of its stock through a very favorable but unrealistic equity analysis was instrumental in attracting investors. From private individuals to pension funds, those who bought Enron's equity came down with the company.

Chapter 10 draws the reader's attention to the Ponzi games that can be played with derivative financial instruments. As Warren Buffett aptly suggested, derivatives are so complex and based on outcomes so distant that parties on both sides of the same bet can book a notional profit. If that means big trading bonuses today, who cares about future losses which may destroy shareholder value and bring a company to its knees?

Chapter 11 explains how securitization of loans can be done, and gives advice on how a company can protect itself from being taken to the cleaners. Chapter 12 presents examples of companies which should have known better about how to avoid a downturn, or a very expensive settlement with clients. Bad loans, derivatives gambles, and basic mismanagement mean that for credit institutions the going is tough. A common point in all of the case studies in this book is that senior management should be much more alert, able to avoid tunnel vision, and steer away from deals which cost much more than they are worth. Market power is one of the most basic conditions for innovation – but not market power at any price.

\* \* \*

Let me take this opportunity to thank Stephen Rutt and Jacky Kippenberger, for suggesting this project, and seeing it all the way to publication, and to Keith Povey and Barbara Docherty for the editing work. To Eva-Maria Binder goes the credit for compiling the research results, keying the text, and preparing the camera-ready artwork and index.

*Dimitris N. Chorafas*

*October 2003  
Valmer and Vitznau*

# Acknowledgments

Many organizations, through their senior executives and system specialists, participated in the research projects that led to the writing of this book and its documentation. The author is grateful to them all. Any opinions, findings, conclusions and recommendations expressed in this material are those of the author.