Why cross the line on ethics in business

Financial scams are as age old as history. From simple Ponzi schemes to complex structured deals orchestrated by Enron or at an Asian sovereign fund recently, the financial world has seen a bewildering range of schemes to defraud banks and investors. From the perpetrator's perspective, it is often financial engineering, and not chicanery, though that's a moot point.

Enron case

When Andrew Fastow, ex CFO of Enron struck a deal with Federal prosecutors for a lighter sentence, he knew that it was no longer a moot point. The partnerships that were set up to hide debt from Enron's balance sheet were clearly in the realm of financial chicanery, and could no longer be considered financial engineering. Until then, he had been quite successful in convincing Wall Street investment banks and his auditors Arthur Andersen, that it was the latter case. Both paid a heavy price. The investment banks paid out billions of dollars in settlement of class action suits and with regulators, while the Big 5 accounting firms list shrunk to the Big 4.

Why Enron resorted to financial chicanery

In the heydays of the nineties, in a scenario of exuberant capital markets ('irrational exuberance' as Greenspan would say) and investor pressure on quarterly earnings growth, CEO's and CFO's were incubating deals which would generate profits from financial deals in addition to what the business generated, hide losses and suppress debt.

Enron Corporation was a classic case. The energy 'trading' business was seemingly well established and Enron was in the lime light in Wall Street. But the earnings coming in from the energy business was simply not sufficient to meet the earnings growth expectations of analysts. Losses were becoming unmanageable in some businesses and earnings proving volatile. Financial wizardry was required to keep analysts at bay in Wall Street. Fastow had been very successful till then in keeping his vast array of bankers at tenterhooks, by making them bid one against the other. The idea of off-balance sheet entities took shape, and required the help of these bankers to execute. These entities, typified by the notorious LJM partnership, Raptor SPE et al, were created to take debt off Enron's balance sheet and to lay the basis for aggressive mark to market valuation of Enron's assets. Deals, involving complex derivatives, were struck with the partnerships, ahead of quarter ends, to be reversed immediately afterwards.

The whole structure unravelled when an employee blew the whistle, Wall Street started reflecting on the Enron stock price its nagging doubts on the Enron partnerships and Special Purpose vehicles and the consequent undercapitalization of the partnerships funded by Enron's stock. In a short period, market capitalization of USD 80 billion was wiped out, and debt of billions was rendered worthless. The pension funds of thousands of employees invested in Enron stock went down the drain.

Lessons to be learnt

Where does financial engineering cross the thin line into the shadowy realm of financial chicanery? What are the lessons for analysts, investors, auditors and investment bankers?

There are two trends that are visible here. Herd mentality was at play, with the best paid Wall Street analysts and investment bankers being no exception. Enron's financial statements had some leads to the gross inflation of earnings, in the form of fine print in the footnotes to its accounts, but the financial community largely chose to ignore it. Analysts and investment bankers chose to accept the financial statements at face value rather than suspect a corporation whose market capitalization, was among the top ten. It is always easier for everyone including the best financial brains in the world, at Wall Street, to swim with the tide, rather than against it. Often it takes a whistle blower like the little boy in the folk tale of the emperor's new clothes, to bring us back to reality.

Is white collar financial crime any different from that of petty theft or robbery? The latter's motive is usually to make two ends meet. It is a bit of an enigma on what impels those already worth millions to indulge in financial chicanery. The US based former head of the world's most prestigious consulting firm was convicted on insider trading charges. Why did a person who had reached the pinnacle of position and prestige want more? One version had it that he wanted to upgrade from the 100 million dollar net worth club to the billion dollar club.

Caesar's wife must be above suspicion

Well, in this case, the adage applies to the private sector bank CEO's husband. The banker in India, who was the darling of the financial press for several years, is suddenly facing a lynch mob from the same media, who had built up her profile for nearly a decade. The press it appears, loves to build, and then destroy, the careers and lives of celebrities. While not getting into the merits of the allegations which are still under investigation, at the very least, it appears to be a classic case of conflict of interest. An upfront disclosure followed by complete and total recusal from the deal in question would have saved the individual from the current traumatic situation and possibly much worse to come. One cannot but feel some pathos at seeing her being pilloried by the press day in and day out, when just a year back she was the most sought after representative of the financial community.

The country is now seeing an extreme case of conflict of interest. Several lakh crores of tax payers money is being used to cover up the hole in the balance sheet of banks. Where did this money go? A good part of it went to large corporates, whose promoters diverted a significant chunk of bank money into their personal coffers rather than using it for financing the projects that the bank financing was intended for. No one has paid the price for it, except the hapless public. Very few culprits have been outed and they too have fled to safe havens abroad.

While we have been unable to bring our big ticket financial criminals to justice, we have chosen to make a horrific example of a private sector bank CEO, whose alleged crimes pale in comparison to the large scale swindling of PSU banks and minority shareholders by powerful promoters.

Are Board positions sinecures?

Board positions in listed corporates can deteriorate into sinecures for retired, formerly powerful public (or private) sector executives. A supine board member beholden to the promoter/CEO for his/her position or in awe of the "professional" CEO, is unlikely to carry any accountability to the minority shareholders. When the promoter seeks the board's approval to sell off the company owned prime property to his/her own family firm at throw away prices or to invest in the promoter/CEO's related entities at inflated prices, the rare board member who asks tough questions about the related party transaction, will soon find the doors closed forever from the small clique of "independent" board members. Similarly, a credit rating agency which is truly objective in its ratings will soon find itself out of business.

Having worked in risk management in some financial institutions, the writer has experienced this. Taking a stringent view on corporate loan proposals pushed by the sales team or senior management, can be hazardous to career prospects. Many risk managers, as a result, are content to make some noise, put some innocuous remarks on record, and let the proposal pass. If the mega loan turns bad down the line, one can always point out the risks which were highlighted on record. Careers are safe, but shareholders are left in the lurch.

Another trend is the outsourcing of investigations by the Board of Directors to external parties, when faced with allegations of financial impropriety, aired in the media. This came under scathing attack by India's "doyen of corporate governance" who founded one of India's most iconic technology companies, but is no longer part of it. An agency hired by the accused, exonerates it of all blame! What credibility do such investigations carry?

A vibrant media which refuses to sweep egregious cases under the carpet, independent board members (though that's a rare breed), and strong compliance and risk management professionals at financial institutions can to some extent keep the offenders at bay. Finally, its caveat emptor, individual investors, lenders and board members who carry fiduciary responsibility to minority shareholders, should be perennially on guard against dubious investment proposals.