BUSINESS LIFE

FAILURE OF BUSINESS ETHICS PART I:

When compliance is not enough.

In the first of three articles, John Plender and Avinash Persaud describe the challenges facing managers in creating an ethical culture.

22 August 2006
Financial Times

THE EXTRAORDINARY expansion of company legislation and corporate governance codes across the world since the collapse of Enron, the energy trader, has had many unintended consequences. One of the more paradoxical is the damage that has been done to business ethics.

The attempt to legislate and regulate people into good behaviour has spawned a compliance culture rather than an ethical culture. Too many boards have outsourced the task of ethics to ethics officers, who have turned to consultants to define the company's values. Ethics have become something that "other people" in the organisation worry about, leaving everyone else unfettered by such concerns. Does it matter? And if it does, what can be done about it?

We will argue in this and subsequent extracts from our book (*All You Need to Know About Ethics and Finance*, Longtail Publishing, Sept. 2006) that ethics do matter in business because they underpin trust, which is fundamental to business relations. Markets work more efficiently where there is trust between participants. Within the company an ethical culture provides the glue that makes for a cohesive and effective organisation.

It is, of course, possible to run an organisation efficiently without trust and without integrity. Colombian drug syndicates do this. But it requires punitive management and control. Where there is a deficiency of ethical values in more conventional business it is similarly necessary to fall back on punitive laws and regulations, although of a less violent kind, such as the US Sarbanes-Oxley Act.

In short, a lack of trust leads to higher compliance costs as more business behaviour is subject to increased legislation and litigation. Moreover, there is a growing economic literature pointing to a relationship between the level of trust in an economy and the development of financial systems and large-scale businesses. Low-trust economies such as China, rely heavily on the family business model and find it hard to build big private sector companies.

What this means in practical business terms has been well expressed by Marvin Bower, who built McKinsey into the world's most admired consultancy (see below). Yet the most compelling case for business ethics is simply what happens without them. The cost of ethical shortfalls at Enron, WorldCom, Parmalat and others is there for all to see.

The problem for boards and managers is thus to find practical ways of establishing an ethical culture and pre-empting potentially damaging unethical behaviour. This is especially difficult for organisations whose operations span many countries and cultures. A case in point is the US financial giant Citigroup, where a rigorous attempt to embed an ethical culture ran into difficulty on the trading floor in London (which will be explored below) and in Japan.

In our view an ethical culture must start not with a code but with individual responsibility. This does not imply a dysfunctional organisation in which employees pick and choose what they wish to do on the basis of their personal ethics. It means an organisation open to questioning and amending its behaviour in response to the ethical considerations of its employees, managers and shareholders and, in appropriate measure, its clients, business partners and the community.

Achieving this is substantially a matter of leadership. An ethical culture has to be embedded, which is a considerable management challenge. Codes are part of this process. In writing codes of ethics it is vital for managers to engage employees throughout the company. A code promulgated from the top, without consultation, will command little support among employees. Excessive reliance on outside consultants will all too easily lead to a bland ethical template that fails to embody the best internal standards, traditions and values. Internal input is helpful to the embedding process.

Leadership also means setting an example. This is more about openness, responsiveness and courage than being saintly or always beyond reproach. It is particularly about taking ownership of decisions and actions. There are many things managers should delegate to others but ethical responsibility is not one of them.

Apart from the notion that ethics are "other people's" problem, the biggest obstacle to establishing an ethical culture is short-term incentive structures. Most recent ethical abuses in the English-speaking countries have been about cooking the books in order to boost senior managers' pay. This has taken many forms, from shuffling costs and revenues from one reporting period to another, to adjusting retrospectively the strike price of stock options. It is pervasive. Jack Welch, former chief executive of General Electric, has admitted that his executives at GE were willing to engage in earnings management, albeit perfectly legally. Royal Dutch Shell, once regarded as a beacon of ethical solidity, fiddled its production reserve figures. Even such innovative technology giants as Apple have been caught up in the options backdating saga.

Such ploys, whether legal or illegal, have occurred in a world where a high proportion of boardroom pay consists of equity and stock options. Increasingly, pay is performance related, with performance being geared to the share price—a variable governed by many factors unrelated to the individual company's performance—or to earnings, which are easily manipulated. Add the pressure on executives from fund managers and analysts to "make the numbers" and you have a recipe for ethical lapses.

These incentive structures in the boardroom and below are subverting efforts to instill ethical behaviour, as well as being commercially disadvantageous. Part of the task of business leaders in the Anglo-American world is therefore to redesign reward systems to ensure they do not undermine ethical behaviour. That means fewer stock options and more plain, if restricted, equity, and less reliance on share price or earnings-related performance measures.

The task of helping people find a moral compass in the complex world of business is a challenging one. But the benefits are real.

FOUNDER OF McKINSEY'S VALUES

COMPANIES that place emphasis on an ethical culture often owe this commitment to the vision of a forceful founder. That is true of McKinsey, the consultancy led for many years by the late Marvin Bower, who believed it was the job of a leader to shape a set of common values that would help an organisation grow.

Executives in well-run companies, he observed, often referred to “our philosophy” or “the way we do things round here”. Such a philosophy evolves as a set of guidelines or rules that gradually become established, through trial and error or through leadership, as expected patterns of behaviour.

McKinsey's stated values today still substantially reflect Bower's philosophy. High ethical standards, he argued, contributed to three main competitive advantages:

- A business of high principle generates greater drive and effectiveness because people know they can do the right thing decisively and with confidence. They know that any action that is even slightly unprincipled will be generally condemned.
- It attracts high-calibre people, thereby gaining a basic competitive edge.
- It develops better and more profitable relations with customers, competitors and the public because it can be counted on to do the right thing at all times.

Under Bower integrity at McKinsey was paramount. “If you are not willing to take the pain to live by your principles,” he once remarked, “there is no point in having principles.” When one of McKinsey's most talented and prolific generators of fees became involved in a serious conflict of interest that violated the firm's values, Bower gave him 30 minutes to clear out.

Letter from Mr Paul Basson, President, Integrity Interactive Europe, 1040 Brussels, Belgium.

24 August 2006

Sir, John Plender and Avinash Persaud (“When compliance is not enough”, August 21) rightly assert that the importance of business ethics has, until now, been dangerously ignored by many corporations. But the debate now needs to move on from whether building and maintaining an ethical corporate culture is a good thing—it absolutely is—to how company managers can use that culture to positive ends.

This will demonstrate how a focus on ethics can create real value for companies, and hopefully encourage more of them to take ethics seriously.

Establishing a unified corporate culture is increasingly important in a global economy where merger and acquisition activity is frequent and often crosses borders. Following a multinational merger—Mittal-Arcelor and O-Telefonica would be recent examples—the management faces a huge challenge in ensuring all employees *understand that the new company has a single identity and, just as importantly, a single set of values to which it works.*

The identity and values apply regardless of whether one works in Brussels or in Vladivostok, as the receptionist or the chief executive. Without this culture, staff motivation and retention—and therefore productivity — decrease and the risk of an ethics or compliance failure greatly increases.

The great corporate leaders understand this and use ethics to build a common culture and demonstrate values from the top.

We have been arguing for a greater focus on ethical culture within business for some time and we hope that Mr Plender's and Prof Persaud's book helps promote it still further.

BUSINESS LIFE

The day Dr Evil wounded a financial giant

FAILURE OF BUSINESS ETHICS PART II: Citigroup's efforts to instill an ethical culture were undermined by the trading controversy, write John Plender and Avinash Persaud.

23 August 2006

OF THE WORLD'S top financial institutions none has done more than Citigroup under Chuck Prince's leadership to address ethical problems and attempt to instill an ethical culture. Citigroup has nonetheless been plagued by high-profile ethical lapses, underlining how difficult it can be to embed sound values in a diverse and complex international organisation.

The challenge when Chuck Prince became chief executive officer in 2003 was that Citigroup was under pressure from regulators and suffering severe reputational damage that threatened to tarnish its brand. It had been a prominent provider of finance, on- and off-balance sheet, to Enron, WorldCom, Adelphia and Parmalat, among others.

The bad publicity was not helped by some very maladroit behaviour by bonus-hungry bankers. A prime example related to Citigroup's role in removing liabilities from the Parmalat balance sheet through a vehicle the bank's executives chose to call Buco Nero—Italian for Black Hole.

On Parmalat's bankruptcy some saw this as symptomatic of a cynical culture aimed at maximising short-term profits regardless of ethical considerations. The cost of settling the resulting lawsuits ran into several billions.

Chuck Prince sought to address the problem by asking the group's 300,000 employees in more than 100 countries to adhere to a new code of conduct. This declared that Citigroup would aspire to be:

- a company with the highest standards of ethical conduct;
- an organisation people can trust;
- a company dedicated to community service.

Yet despite huge efforts to embed the code through training programmes and ethics courses, it became a hostage to fortune when Citigroup's London operations were mired in controversy over a trade in the European sovereign bond market that raised important ethical issues.

In July 2004 the European government bond desk was under pressure to increase profits. So the traders planned a move that came to be known as the Dr Evil trade. It aimed to exploit a weakness in the structure of the Italian-based MTS electronic bond market, in which marketmakers had to commit themselves to quote prices for bonds for at least five hours a day for minimum amounts.

On a quiet day in August the trading desk placed sell orders worth €11.3bn in 18 seconds, which was equivalent to a full average day's trading volume on MTS. Together with further sales of €1.5bn on other domestic bond markets the total sale of no fewer than 200 different bonds was worth nearly €12.9bn. It then bought back bonds the same morning at a lower price, earning a profit on the deal of €18.2m. Competitors were stung for losses of €1m–€2m apiece.

To prevent a repetition MTS restricted trading and many banks refused to honour their commitment to make a market for fear of another mass order. Trading volume on MTS declined by more than 30 per cent in the three months afterwards, causing European governments to worry about a rise in the cost of servicing their debt.

From an ethical point of view, some outside Citigroup as well as within argued that this was a market for professional traders who knew how to look after themselves. In this view, exploiting a structural weakness in the MTS market was fair game. Others felt Citigroup had cynically breached a gentleman's agreement central to the workings of the market. Either way, Citigroup's traders were undoubtedly flouting the bank's stated ethical values which declared that "we treat our customers, suppliers and competitors fairly".

From a business perspective the trade was a disaster. Angry European governments withdrew business from Citigroup. Britain's Financial Services Authority imposed a fine of £14m for a failure to exercise due skill, care and diligence, together with failures of internal control and risk management—its highest ever fine. An investigation by MTS's own independent appeals board found that Citigroup had prejudiced the smooth operation of the market in the long run; shown a lack of professionalism in its disregard of how the trade would affect MTS; and been incompetent in the execution of the trade because of a failure to test software properly.

In a leaked e-mail, Tom Maheras, Citigroup's head of global capital markets, admitted that "we did not meet our standards in this instance and . . . we failed to fully consider (the transaction's) impact on our clients, other market participants and our regulators". Chuck Prince called the trade "knuckleheaded". Yet in due course the traders, briefly suspended, returned to work. There was no news of anyone being fired.

The morale of those who did believe in the values was thus undermined. As one (understandably anonymous) employee put it to us: "Not to fire these bond traders or their management is to internally celebrate their doings and it has led to an uncomfortable vacuum about what values the organisation stands by and what the strategy is."

This, then, was a classic example of how a huge effort to instill values could be subverted by top executives' failure to enforce them.

Letter from Michael Schlein, Global Corporate Affairs, Human Resources and Business Practices, Citigroup:

29 August 2006

Sir, Your article "The day Dr Evil wounded a financial giant" (August 23) is wrong on its basic facts.

The article's basic premise that "lapses" at Citigroup occurred despite the "huge effort" of our Five Point Plan is inaccurate. The "lapse" cited by the authors occurred well before the our "huge effort" and, in fact, partly inspired what would become a worldwide effort to strengthen controls, improve training and instill a renewed and consistent set of shared responsibilities among our 300,000-plus employees—an effort that has gained widespread recognition for its success from many observers.

The article further errs on the subject of Parmalat, claiming that "the cost of settling the resulting lawsuits ran into several billions" of dollars. This is wrong. Citigroup was a victim of this fraud and we have not settled any lawsuits relating to Parmalat.

The authors of this book excerpt did not check the facts on their "Citigroup Case Study" with Citigroup, nor did the FT check the facts before printing the article.

BUSINESS LIFE

The market discipline that is not so tight

FAILURE OF BUSINESS ETHICS PART III: A trading scandal that hit GE highlights the dilemmas executives face in presenting results, write John Plender and Avinash Persaud.

24 August 2006

IN THE Anglo-American model of capitalism the stock market imposes a ferocious discipline on managers of quoted companies.

For a start, the movement of the share price offers a minute-by-minute critical commentary on corporate performance and prospects. Quarterly results are closely examined by stock market analysts, fund managers and journalists, and there is an ever-present threat of hostile takeover. The credibility of top executives in this system depends on their generating consistent increases in earnings. They also have to develop the art of carefully guiding analysts' expectations and subsequently "hitting the numbers".

Putting chief executives into a financial pressure cooker in this way has disadvantages, not least the pressure to lose their moral compass and cook the books. The underlying assumption is that companies are capable of delivering consistently rising, above-average earnings. Yet not all companies can be above average.

Equally absurd is the assumption that accountancy is an objective science capable of producing a single exact number that is worth hitting. As for the discipline, it is peculiar, in that top executives set the benchmarks against which they themselves are measured.

Because so many employees now own stock in the company where they work, the categorical imperative of hitting the numbers may be felt throughout the organisation. Inevitably there is a temptation, in this ritualised expectations game, to massage results to keep the stock price up. Where performance criteria for bonuses and stock incentive schemes are related to the the behaviour of the stock, such temptation is acute.

In the wave of corporate scandals from Enron to Royal Dutch Shell, this pressure drove top executives to juggle the numbers in ways that boosted their own compensation packages. Yet it is also open to executives to tailor quite lawfully their spending decisions and choice of accounting policies in order to smooth the quarterly earnings trend.

The nature of these dilemmas emerges in a surprising way in the autobiography of Jack Welch, former chairman and chief executive of General Electric, when he recounts the disaster that struck the conglomerate's investment banking subsidiary, Kidder Peabody, in 1994.

Kidder's bond trading desk was run by Joseph Jett, who made a series of fictitious trades to inflate his own bonus. These artificial trades had inflated Kidder's re-ported income and the team of GE managers assessing the damage concluded, with GE's first-quarter earnings release due to be published in just two days time, that a $350m write-off would be needed to deal with the financial black hole left by the rogue trader.

Mr Welch explains how he apologised to 14 of GE's business leaders for what had happened and felt terrible because it would hit the stock and hurt every GE employee. He continues: "The response of our business leaders to the crisis was typical of the GE culture. Even though the books had closed on the quarter, many immediately offered to pitch in to cover the Kidder gap. Some said they could find an extra $10m, $20m, and even $30m from their businesses to offset the surprise. Though it was too late, their willingness to help was a dramatic contrast to the excuses I had been hearing from the Kidder people."

"Instead of pitching in, they complained about how this disaster was going to affect their incomes. 'This is going to ruin everything,' one said. 'Our bonus is down the toilet. How will we keep anyone?' The two cultures and their differences never stood out so clearly in my mind."

For Jack Welch the ethical issue here boils down to the contrast between the greedy, footloose individualism embedded in the culture of Wall Street and the healthy team spirit exemplified by managers in GE's mainstream businesses. He seems blind to the possibility that others might be shocked that the GE culture was one in which playing fast and loose with the quarterly numbers was regarded as good teamwork.

Some might argue that on the Richter scale of ethical lapses this does not rate high. Mr Welch could no doubt claim that such smoothing of the numbers is an antidote to stock market short-termism and thus in the interests of all shareholders.

Yet while massaging the numbers may be a rational response to the somewhat arbitrary discipline of the expectations game, there is a question about whether shareholders should have been told on what basis this was being done at GE, not least because such opaque reporting can put management on to a slippery slope. The risk in creative accounting is that managers end up fooling themselves about the profitability and viability of the businesses they run.

Deciding whether shareholders are being seriously misled is one of business's countless ethical grey areas. It is nonetheless possible to highlight questions executives should ask in relation to smoothing the numbers.

The most basic query concerns failure to be open with shareholders about earnings manipulation. Is it really in shareholders' interest for the short-term earnings trend to be smoothed or are they being kept in the dark to protect executives' jobs, bonuses and other equity-related awards? Is there a risk that the short-term benefit to the share price of massaging earnings will be outweighed by longer-term adverse consequences? Or, more crudely, are earnings being relentlessly massaged against a background of deteriorating corporate performance in the hope that something will turn up?

Openness in business is usually a good principle, except where it would inflict competitive disadvantage on the company concerned. In the context of earnings manipulation, a very basic principle would be that managers should "tell it like it is" unless openness would demonstrably inflict damage on shareholders and other stakeholders.

That said, the capital market expectations game is a flawed form of accountability. It reduces the relationship between managers and shareholders, and the analysis of corporate performance, to an oversimplified credibility test. The wider question for those involved is whether to play at all. In the US, Coca-Cola has led the way in refusing to offer guidance on quarterly earnings. That is one useful way to reduce the ethical pressure.