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ETHICS, GOVERNANCE AND RISK MANAGEMENT:

- LESSONS FROM MIRROR GROUP NEWSPAPERS AND BARINGS BANK[1]

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ABSTRACT

While corporate failures, such as Enron and WorldCom, have focused attention on issues of business ethics, corporate governance and risk management, there is nothing intrinsically new in the reasons behind their collapse. Neither is there anything fresh in the media's rush to identify a 'scapegoat'. An examination of the financial collapse of Mirror Group Newspapers and Barings Bank, demonstrates failures within both these companies' corporate cultures and management systems, which allowed, if not encouraged, unethical behaviour by key individuals. It is argued that a combination of legislation, regulation, effective risk management and appropriate sanctions are needed, if such unethical behaviour, and resulting corporate failure, is to be prevented in future.

Introduction

Although the failures of both Enron and WorldCom have focused greater attention on the issues of business ethics, corporate governance and risk management, there is nothing intrinsically new in the reasons behind their collapse (Fusaro and Miller, 2002; Elliot and Schroth, 2002). It can be tempting to believe that such major business catastrophes 'could not happen here'. The UK accounting bodies have, however, pointed out that other countries, and in particular the United Kingdom, are not without their own corporate failures (ICAEW, 2002). A series of financial scandals in the UK private sector, during the 1980s and early 1990s, led to the introduction of a series of codes on

corporate governance, which in turn acted as a driver for risk management (Drennan, Beck and Henry, 2000). These incidents covered a wide range of abuses, and involved a number of well-known companies. It was clear that the existing system of self-regulation, as well as the ability of the judicial system to identify and penalise misconduct, was sadly lacking and largely ineffective (Arnold and Sikka, 2001).

The Risk Management Process

The use of the term 'risk management' first emerged in the United States in the 1950s and largely grew out of the insurance-buying function (Young and Tippens, 2001, p.6). Enlightened managers were seeking strategies which would help to manage the company's risks, rather than simply finance them, after the loss-making event had occurred. The process of risk management is now accepted as a continuous process, whereby the first stage is to identify the organisation's strategic objectives, and the threats to their successful achievement. Secondly, the potential threats are evaluated, in terms of their probability of occurrence and likely impact on the business. This analysis allows the third stage to occur, in which decisions are taken on the prioritisation of treatment of the risk, otherwise known as risk control, and on the financing of any residual risk. Finally, plans are drawn up to ensure that the business can function effectively, following a major incident, and a monitoring system put in place in order that any changes, which might impact positively or negatively on the achievement of the strategic objectives, can be addressed.

With its origins in insurable risk, early risk management practice tended to concentrate on physical risks, such as fire, employee injury, and damage to machinery and plant (Hood et al, 1992, p.135). During the 1990s, this remit widened, with many risk managers attempting to take a more holistic, enterprise-wide approach and applying their skills to more business-oriented risks (Hopkin, 2002, pp.184-190), such as failures of governance, breaches of corporate social responsibility and unethical behaviour, all of which might result in damage to the organisation's reputation, reduced stakeholder confidence, financial losses and, ultimately, corporate collapse.

Risk management is predicated on the prevention, or minimisation, of threats to the enterprise, and in creating an environment in which the best business decisions might be made. Similarly, it has been argued that good business ethics bring business benefits; that behaving ethically is not only socially beneficial but also economically profitable (Sison, 2000, p.290). Joyner and Payne (2002, p.298) suggest two reasons for such behaviour. The first relates to the company being 'ethical in nature', such as the Body Shop, where the desire to do the right thing for workers in the third world, or for the environment, is core to the company's business strategies. Joyner and Payne's alternative rationale is the 'machiavellian', where the interest in ethical behaviour may be rooted more in convincing stakeholders that the right things are being done, in order to attract them to conduct business with the firm, or possibly in an attempt to avoid the legal consequences of an ethical failure, with oil companies being held as possible examples, in this respect.

From a risk management perspective, it is the extent to which unethical behaviour might be prevented, or the damage caused by such behaviour limited, that is of interest. Francis and Armstrong (2003, p.377) argue that an ethical risk management strategy has to be concerned with both directives that guide ethical business practices, and incentives to promote such conduct, within the organisation. There is little doubt that the public and media attention to corporate, and individual, behaviour is greater than ever. A feature of such interest is the apparent desire to place the blame on an individual, or individuals, for a corporate failure, as has been seen in the case of Enron and its Chief Executive, Jeff Skilling. Clark (1997, p.223) describes this as a media obsession with the demonisation of individual characters. This selective emphasis on the individual often disguises the culpability of the organisation as a whole, and the series of management and systems failures, which created the circumstances in which the abuse could take place. These generally become apparent in later, more careful enquiries. Such was the case with Robert Maxwell, the Chairman and Chief Executive of Mirror Group Newspapers and Nick Leeson, a trader on the Singapore International Monetary Exchange (SIMEX) for Barings Bank. In both cases, it can be argued that the collapse of their respective companies was due not only to individual failure to behave in an ethically and socially responsible manner, but also to a failure in the corporate culture and management systems of the organisation, which allowed, if not encouraged, such behaviour.

Robert Maxwell and Mirror Group Newspapers

Mirror Group Newspapers (MGN) collapsed in 1991, however the history of its Chairman and Chief Executive, and his record of unethical business practices, goes back twenty years. In 1971, Robert Maxwell was described, in a Department of Trade and Industry (DTI) report into Pergamon Press Ltd, as *'not a person who can be relied on to exercise proper stewardship of a publicly quoted company.'* Although losing control of Pergamon in 1969, Maxwell re-acquired the company in 1974, returning as its Chairman. Then, in 1980, he acquired a controlling interest in British Printing Corporation plc, which was on the brink of insolvency. By restoring both these companies to profitability, Maxwell re-established himself in the eyes of many bankers, ensuring their support for future expansion.

Undoubtedly, Maxwell's most significant acquisition took place on 12 July 1984, when his private companies acquired Mirror Group Newspapers (MGN) from Reed International for £113m (DTI, 2001, s.1.19). He assumed complete control over its management and finances, and gradually restored it to profitability by ending restrictive labour practices and introducing modern technology. Mirror Group Newspapers, and Pergamon Press's scientific journals, had strong cash flows and Maxwell used £300m of this to finance other businesses (DTI, 2001, s.4.32).

Maxwell dominated the running of all his companies (DTI, 2001, s.2.7 and s.4.13). He personally controlled the movement of cash within, and between, his companies. Cash was borrowed from the pension funds on a regular basis, and the pension funds made

substantial investments in Maxwell Communication Corporation (DTI, 2001, s.2.20 to 2.48 and Appendix 8). The presentation of the financial position of Maxwell's companies and the pension funds in the annual accounts was carefully managed and the minimum disclosure made. These practices were known to other parties, including Maxwell's son, Kevin, and - perhaps more significantly - to the company's auditors at the time, Coopers and Lybrand Deloitte (DTI, 2001, s.2.12 to 2.13).

In 1987, Maxwell's business operation ran into difficulties and debts built up. Maxwell started to make greater use of the pension funds (DTI, 2001, s.2.34). Banks found it difficult to gain a clear picture of the financial strength of his empire as Maxwell's practice was to be economic with the information supplied to them (DTI, 2001, s.3.20). Although all the groups of companies and pension schemes within Maxwell's empire were audited, they were not audited at a common date, nor was there any overview of the business empire as a whole (DTI, 2001, s.13.4).

By the summer of 1990, in a less favourable economic climate, Maxwell's private and public companies faced a substantial financial crisis. The decision was taken to float MGN on the London Stock Exchange, by selling 49% of the shares (DTI, 2001, s.6.74). Unfortunately, the proceeds were not enough to cover existing debts. Matters came to a head in October 1991, when Goldman Sachs requested repayment of two loans. When repayment was not made, the bank started to sell Maxwell Communication Corporation shares, provided as collateral, and the share price fell substantially. Another bank, Lehmans, then demanded repayment of their financing (DTI, 2001, s.21.78). The

collapse of Maxwell's empire was imminent, when news came that he had drowned, after falling from his yacht in the Mediterranean on 5 November 1991.

The collapse was devastating for many MGN pensioners and for employees of the collapsed companies, who faced redundancy. Criminal charges of fraud were brought against Maxwell's sons but they were cleared at the subsequent trial. However, the DTI report stated that Kevin Maxwell bore a heavy responsibility in respect of many of the events, as did others in Maxwell's management team, and amongst his external advisers (DTI, 2001, preface).

Maxwell undoubtedly behaved in a highly unethical and socially irresponsible manner. Described as a 'bully' by many who worked with him, Maxwell was, at the same time, a highly charismatic individual; a leader who demanded blind obedience in his followers, as Jeff Skilling did in Enron (Khurana, 2002, p.7). Such obedience led both MGN and Enron to corporate collapse, ruined the lives and retirements of people who had worked for these companies for many years, and caused considerable financial damage to a range of other stakeholders. Maxwell may have been a 'rogue', but there were other individuals within the company, and external to it, who went along with his plans, because it suited them at the time. Nonetheless, this idea of the rogue individual, as the sole person to blame for a financial collapse, was similarly promoted, and then discredited, in the case of Nick Leeson and Barings Bank.

Nick Leeson and Barings Bank

Nick Leeson was the so-called 'rogue trader' (Leeson, 1996). Yet the reports into Barings Futures (Singapore) Pte Ltd [BFS] exposed the fact that he was not the only one who knew, or should have known, that something was very wrong with the way in which deals were undertaken, and losses concealed (Bank of England, 1995; San and Kuang, 1995). Leeson first started working for the UK firm, Barings Securities Ltd (BSL), in 1989 and in early 1992 he applied for registration as a dealer with the Securities and Futures Authority (SFA) in England. However, the SFA discovered that Leeson had made a false statement on his application form, about unsatisfied judgement debts against him. The SFA queried BSL on this matter and BSL subsequently withdrew the application.

In April of that same year, Leeson was posted to Singapore and was involved in trading at BFS, as its floor manager at SIMEX (the Singapore International Monetary Exchange). Leeson's previous history was never communicated to SIMEX and in his application to SIMEX, Leeson made a similar false statement that no judgement in civil proceedings had ever been entered against him. While Leeson's trading role at BFS was intended to be limited, it gradually changed over time and, by the end of 1994, Leeson was considered to be one of the major contributors to the profits of the Baring Group (Drummond, 2003). Leeson stood to personally gain out from this success. In 1993, his bonus was £115,000. In 1994, it was expected to reach £450,000 (Stein, 2000, p.1221).

The management systems required Leeson to report to both his local managers in Singapore, and his product managers in London, but this did not work in practice. Leeson transacted his fraudulent activities through a special account that Barings said was unauthorised and that they had no knowledge of, but the inspectors investigating the collapse took the view that they either knew, or should have known, about it and of the losses incurred through the transactions on that account (Brown and Steenbeck, 2001).

In the third quarter of 1994, BFS was internally audited. The auditors were concerned at the powerful position that Leeson was occupying. As both Chief Trader *and* Head of Settlements, he was in a position to record the trades he had made, in any way he wanted. An internal audit report specifically highlighted this point, stating that it created a significant risk, as internal controls could be over-ridden. But the Baring Group already knew this, and nothing was done to remedy the situation. It was probable that, until February 1995, Barings could have averted financial collapse, by taking timely action to prevent it (San and Kuang, 1995: ES36). Instead, matters were allowed to get worse.

After the Baring Group's failure, senior management of the company continued to deny knowledge of Leeson's activities, however the report undertaken on behalf of the Minister of Finance in Singapore found that:

> [they] could have been ignorant of the account up to the time of the collapse only if they had persistently shut themselves from the truth. (San and Kuang, 1995, ES36)

This analysis raises the question as to why Barings, an old established firm of merchant bankers with links to the aristocracy of England, would behave in such a manner. Stein (2000, p.1222) suggests that what Barings did was to respond to the massive changes that were taking place as a result of the 'Big Bang' - the de-regulation of the UK financial services market - by creating as a 'saviour', a 'shadow' to themselves, in the form of the highly risky 'Baring Securities' operation. The firm then chose a number of extreme risk takers, including Leeson, to run this operation. Leeson was introduced to the chief executive of Baring Securities, as the 'red-hot trader' from Singapore, second to none (Stein, 2000, p.1220).

As the evidence of Leeson's misdeeds built up, Barings' senior management either would not, or could not, believe it. They continued to support him till the bitter end. The scale of corporate misjudgement was staggering and the resulting collapse of the firm was spectacular. Barings' directors failed to assess the risks of the strategies that they were employing and, further, failed to understand the responsibility they bore for the events that unfolded. It is events such as these that have focused increasing attention on corporate governance, as a means of ensuring that the Board operate effectively, responsibly and in the best interests of its shareholders and other stakeholders.

Corporate Governance

There is no doubt that both Maxwell and Leeson were individually instrumental in the collapse of their respective organisations. But they were able to get away with it, for as long as they did, because their actions were not questioned by others, and the systems

which should have been in place to prevent such abuse were inadequate. Clark (1997, p.232) describes it in these terms 'behind the façade of rogues and scoundrels are corporations and industry practices'. The corporate governance codes, which have been introduced in the UK during the 1990s, go some way towards preventing this type of situation from arising again (Drennan, Beck and Henry, 2001, p.31).

Corporate governance demands that the process of risk management is monitored as to its appropriateness and effectiveness, and that it is embedded throughout the organisation. Such embedding may require some cultural change. Although risk management is undoubtedly part of the job function of every person in the organisation, this message needs to be communicated and, furthermore, accepted by staff. To aid this process, bureaucracy needs to be kept to a minimum. If risk management, like other initiatives before it, becomes a box-ticking exercise then the potential for real management of risk - for the benefit of the organisation, its staff, clients and the public - will decline.

However, there are serious questions to be asked as to whether the prevailing cultures in many existing organisations would support such a risk management process, and whether the new corporate governance guidelines will prevent future governance failures? Different organisations - even those within the same industry sector - will have varying levels of risk tolerance. In other words, some will be inherently more risk-taking than others. Risk management is not about eliminating risk altogether. Instead, it is concerned with assisting the organisation to make the best decisions it can, when faced with a highly uncertain, and potentially volatile, future.

Learning Lessons

Whenever a major incident occurs, it is important to analyse the factors involved in the incident, with a view to learning lessons and preventing similar events from occurring in future. Private and public inquiry reports, such as those carried out by the DTI, the Bank of England and the Singaporean Ministry of Finance, inevitably draw attention to a catalogue of mistakes and individual failures. There are always warning signs, in the lead up to a major incident, however these are often ignored or undervalued by key participants (Fink, 2000). The value of inquiry reports lies in the recommendations that are made for changes in operational and management practices, in regulation and legislation.

The DTI report into MGN concluded that many of the deficiencies in legislation and regulation, which permitted those events to occur, had been rectified by the date of publication, but they listed 8 areas which still required some consideration (DTI, 2001). Amongst these was the issue of the accountability of non-executive directors, and the separation of the offices of chairman and chief executive. The report suggested that further guidance on the duties of all directors was necessary.

> The most important lesson to be learnt is that high ethical and professional standards must always be put before commercial advantage. The reputation of the financial markets depends on it. Legislation and regulation is, however, of great importance in underpinning those standards. (DTI, 2001, s.23.2)

One of the undesirable features of MGN, on flotation, was that it had an executive chairman, and no separate chief executive. The DTI report agreed with the recommendations of the existing combined code on corporate governance (the Turnbull Report) that these offices should not be combined. However, a recommendation is not mandatory. For this reason, the DTI doubted whether the provision in the current corporate governance Combined Code would be sufficient to prevent this type of governance breakdown, in future (DTI, 2001, s.23.85).

In the case of Barings, the Bank of England questioned the awarding of sizeable bonuses as one possible motivation for Leeson's fraud (1995, s.13.79). This practice was not, of course, confined to Barings and indeed could be argued to have played a major part in the downfall of Enron (Fusaro and Miller, 2002, p.40). High bonuses encourage high risk behaviour, with no guarantee that the outcome will be favourable to the organisation concerned.

Managing the Risk

In order to manage the threat of an individual or corporation behaving in an unethical and/or socially irresponsible manner, there is a need to employ a range of strategies, to prevent, mitigate and, ultimately, punish such behaviour. More robust legislation and regulation, and the introduction of codes of corporate governance may reduce the risk, but cannot eliminate it entirely. The organisation itself must ensure that adequate controls are in place to prevent fraud and other forms of dishonest dealing. Such controls should not act as a curb on entrepreneurial behaviour, but aim to keep it within legal

boundaries (Leigh, 1982, p.203). It has, however, to be accepted that rogue individuals will continue to find ways around the systems in their own organisations.

A further approach is therefore to strengthen the roles and responsibilities of the board. The UK Government's proposed new Companies' Bill seeks to codify directors' duties and provide guidance on them (2002, s.11). Codification would result in breaches of duty being dealt with by the criminal, rather than the civil, law (Copeman, 2000, p.75). Criminal sanctions have also been supported in the Higgs Report (2003, s.14.12), with the importance of adequate training and guidance for directors also being highlighted (s.11.1 and s.11.14).

Higgs, as Turnbull before him, calls for the separation of the roles of chairman and chief executive (2003, s.5.3) however, in his covering letter to the Chancellor of the Exchequer, he supports the flexibility within the current Combined Code:

> I am clear that the fundamentals of corporate governance in the UK are sound, thanks to Sir Adrian Cadbury and those who built on his foundations. The Combined Code and its philosophy of 'comply or explain' is being increasingly emulated outside the UK. It offers flexibility and intelligent discretion and allows for the valid exception to the sound rule. The brittleness and rigidity of legislation cannot dictate the behaviour, or foster the trust I believe is fundamental to the effective unitary board and to superior corporate performance.

Whether the tightening of legislation and increasing use of criminal sanctions, or stricter adherence to codes of corporate governance, can prevent an MGN or Barings-type collapse in future is debatable. Cadbury (2002) argues that it is the quality of the individual, and his honesty, integrity and prudence that is the greatest safeguard.

> Companies need to recruit and train people in whom they have confidence and whom they can trust. It is confidence and trust that are real safeguards against fraud and disaster, and they can only be fostered and instilled on a sound ethical basis (Cadbury, 2002, p.22).

Thus, in managing these types of threat, good human resource management and development is essential, in addition to effective systems of internal control that will monitor and review the performance of both directors and employees. Joyner and Payne argue that a stronger case might be made for ethical behaviour and corporate social responsibility if a clear link could be found between changes in culture and the financial performance of the firm (2002, p.310). Nonetheless, the reputation damage that results from a failure to behave ethically, or even the public perception that a breach may have occurred, provides a powerful incentive in its own right.

The responsibility for ensuring that all of the business risks are effectively addressed lies with the board of directors, both individually and collectively. The impulse for ethical business has to come from the top (Schroeder, 2002, p.265). Unethical behaviour, or 'business criminality', is learned and those who create the culture within an organization

have an important influence on their subordinates (Leigh, 1982, pp.207-208). Thus, members of the board of Barings Bank, and its senior management, were as culpable as Leeson, in allowing (whether explicitly or implicitly) activities to take place that ultimately led to the ruin of their company. In the case of Mirror Group Newspapers, the dominating style of the CEO was left unchallenged by board members, and significant external parties, leaving Maxwell free to take unethical business decisions and commit fraud.

If the proposed UK Companies' Bill is enacted, companies and their directors will have to be prepared to accept a greater portion of the blame for failures. The UK is not unique, in this respect, as countries across the globe move towards tightening legislation that may prevent fraud and protect employees and shareholders. The high profile being given to the Sarbanes-Oxley Act of 2002, in the United States, is one example of a legislative drive to control corrupt business practices and encourage ethical behaviour. In this case, the aim is to ensure more accurate and transparent reporting of financial information, by making the key corporate office bearers personally accountable for the verity of the information being provided to stakeholders.

Conclusion

While risk management was initially concerned with physical risk, we now see its techniques being employed in less tangible areas of the business operation, such as ethics and governance, and the protection of corporate reputation. The control of any threat to an organization's objectives, whether internally or externally derived; arising from a

failure in management, technology or human behaviour, requires the same systematic approach to be taken. Risk management demands a rigorous process of identification, evaluation and treatment, as well as the creation of continuity plans, in the event of things going wrong.

The introduction of new legislation, and more strict codes of conduct, has led to a greater awareness, at board level, of the need to manage the broad range of threats to the success and continuity of the business operation. Legislation and regulation are, however, insufficient in themselves, as risk management measures, and are unlikely to win 'hearts and minds'. If a corporation is to ensure that all its board members, and employees, operate in an ethical manner and that its structures deliver good governance, then this takes commitment from the top. Developing an ethos in which ethical behaviour is actively encouraged, along with systems for the early identification of ethical or governance breakdowns, will help prevent the reputation damage – both personal and corporate – that follows the collapse of an enterprise. Effectively managing the risks is key to corporate survival. Failure to do so, as MGN, Barings, and others have found, can extract a very heavy price.

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