GRAS Newsletter 48

July 2012

Quiz time: What is More Damaging? □Fraud □Incompetence □Greed

Summary
The start of this month has given the newspaper readers plenty of reason to either laugh, curse or despair about banks. At least six major OpRisk events made headlines again in the month ending 1st of July. Categorising these events by their prime drivers (Fraud, Incompetence, Greed) we examine which of these drivers make the biggest impact.

Dear reader,
In the ORM world, it is a common parlour game to speculate about the full impact of OpRisk events. Especially in headline cases, the impact is always believed to be a multiple of the direct loss. An often quoted statistic in ORM circles - although never fully substantiated - is that after 120 days, the full effect in terms of shareholder value equals 12 times the direct loss amount. The full impact is calculated as a combination of the effect on both the share price and dividend pay outs. Since the month of June has been such a bumper month for OpRisk Events[1], it is worthwhile to examine these cases in some detail to see what we can learn from them regarding losses and their impact. In true operational risk style, we will take a root cause approach, focusing on the human aspect of the cases. We distinguish three behavioural types that underlie these cases: Fraudulent, Incompetent and Greedy behaviour[2]. Which do you think will have the most impact?

It is the whole bank, not just those caught red-handed
A first clue may be given by looking at the history of the bank's performance. The reason for this is that big events are a sign of an underlying weakness, not a single case of 'bad luck'. Banks usually try to hide behind the 'exception circumstances surrounding this case', always insisting that it was a lone rogue trader or a lone greedy investment manager who overstepped his authority, or a lone incompetent employee who made the errors or exhibited inappropriate behaviour. But nothing could be further from the truth. Time and time again, we have seen that, when a case comes to light it has been in the making for months and sometimes years with plenty of people who turned a blind eye to the red flags for reasons of complicity, ignorance or greed: exactly the set of behaviours we wish to examine.

A good place to start the investigation is see how the banks have been performing over the last year, starting with the most public of information, the development of the share price. Consider the diagram below that shows the year on year percentage change of the NYSE share price for the six

[1] To name the three best known: the JPMorgan Chase got greedy with a runaway hedge fund, Barclays' was fined for fraudulent behaviour regarding the setting of Libor and The RBS suffered a near total breakdown of public services for several days as a case of sheer incompetence. Lesser known but major events also occurred at: Wells Fargo that incurred a FINRA fine for greedily selling leveraged and inverse exchange-traded funds 'without reasonable supervision'; UBS that faces a class action suit regarding the fraudulent behaviour in making materially false and misleading statements regarding UBS's disclosure controls, procedures and internal controls over financial reporting, stating that these controls and procedures were effective when, in fact, they were not. This in responses to the rogue trader, Kweku Adoboli. Finally, Credit Suisse was investigated by the SEC for the incompetence shown in failing in their oversight of traders that had been able to manipulate and inflate cash bond positions.
[2] Greed and Fraud, and indeed Incompetence often overlap. Here, greed is restricted to taking on disproportionate risk without deception whereas Fraud is anything involving deception.

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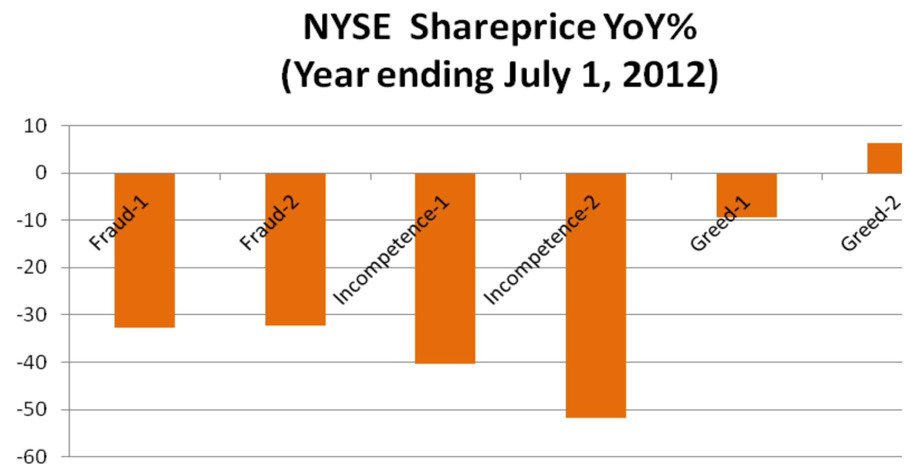
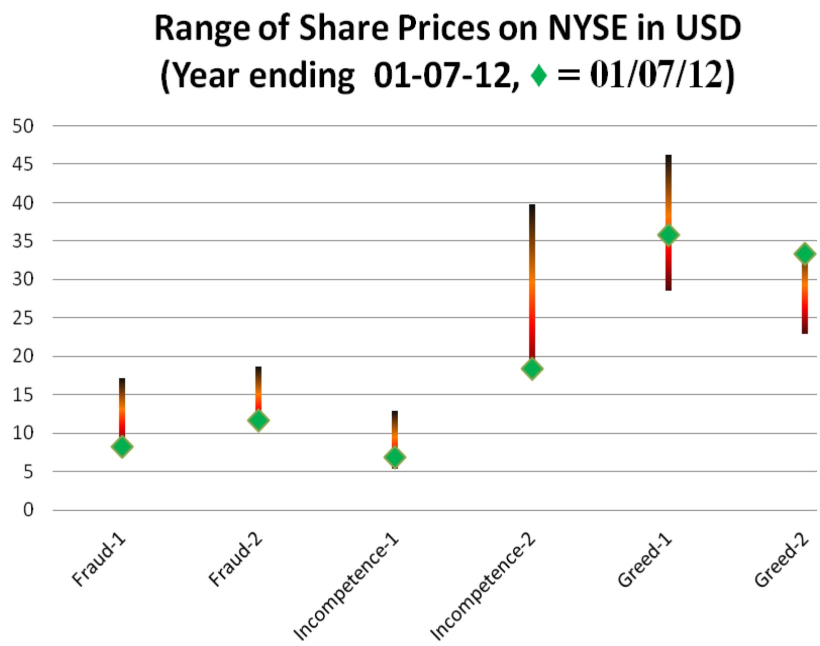
cases under investigation.[3] Banks have not been good investments but it is clear from this diagram that there are huge differences within the banking world. Five out of the six banks are down YoY, but the real story is that the banks who were involved in fraud and incompetence suffered significantly more than those who were merely greedy. One 'Greedy' bank managed to even pose a 6% increase in share price, whereas the most Incompetent bank lost 52% of the share price. Both banks singled out for Fraud lost 32% of their share price. On the next page, we will also trace these banks in the two weeks following 1st July 2012, but you may wish to jot down your expectation before looking at that.



Where did they end up?

To show where the events have lead the banks, we need to look a little further. The next diagram shows the highs and lows of the share price over the last year, including the share price on 1st July 2012, our reference point. Again, it shows that Fraud and Incompetence have a far greater negative impact than Greed. In the first four cases, the share price sunk to the bottom of the range, but the banks involved in Greed-related cases do much better. Greed-1 is about 30% up from the bottom and Greed-2 is even riding a high.



[3] For those who like to delve deeper into this, the legend is as follows: Fraud-1 = Barclays, Fraud-2 = UBS; Incompetence-1 = RBS; Incompetence-2 = Credit Suisse; Greed-1 = JPMorgan Chase; Greed-2 = Wells Fargo. Details about the actual cases available upon request. All of these cases are likely to make an appearance in future External Loss data collections. The classification of these cases is, admittedly, subjective.

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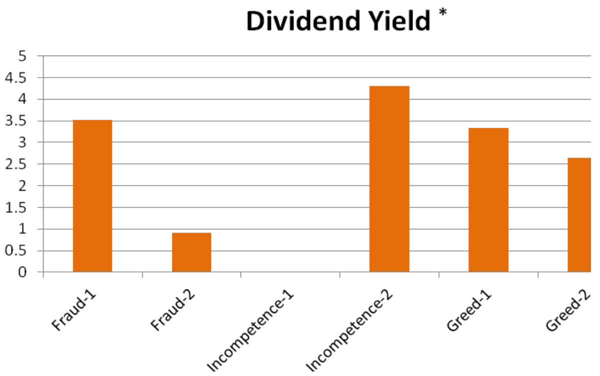
That is all well and good, but what about dividends? Here, the picture is more mixed. One incompetent bank has not made any dividend payments last year and hence their dividend yield is zero. The highest dividend yield of 4.3% is for a fellow sufferer of OpRisk events associated with Incompetence. For the Fraud related incidents, the most visible case still has a respectable dividend yield of 3.52%, the other Fraud case lingers in the doldrums at 0.92%. Greed seems to doing OK in general, with a dividend yield of 3.33% and 2.64. No clear winner therefore by this measure, although the Fraud and incompetent yields are propped up by the much reduced share price.



* Dividend Yield is defined as the value of the latest dividend multiplied by the number of times dividends are typically paid per year, divided by the stock price. It is a ratio that can be compared directly between companies.

Note also that once a Fraud or a case of Incompetence has come to light, there will be a clear incentive on the part of the bank to show that it is dealing with the issue. Not only do regulators expect that action will be taken, shareholders will also want to be reassured that it will not happen again. Hence, they may even be more willing to forego dividends to ensure the risk is better controlled in future. For the Greed related cases, however, it is not that clear that shareholders even want the banks to be less 'greedy'. Which shareholder will gladly forego some dividend to ensure that the bank does not take outsize risks? Only that rarest of shareholder, the one who does not clamour for outsize returns.

Recent developments

Keeping track of what the press writes about famous cases is fun, but also tiresome. Collecting all press cuttings from the FT in the two weeks from July 1st to July 14th, we come to a grand total of 128 articles about these cases. That is an overwhelming amount of attention. The attention is also very unevenly split. The table below illustrates this:

	Fraud		Incompetence		Greed	
	1	**2**	**1**	**2**	**1**	**2**
Number of articles	98	4	11	1	12	2
Coverage in 100 cm^2	305	15	14	2	30	4
Number of days in FT	12	3	4	1	4	2

Table 1. Coverage in the Financial Times of the six OpRisk cases between July 1 and July14.

Each category clearly had a 'leading case', with the Fraud case getting the bulk of the attention. This is not surprising since it involved one of the pillars of banking, Libor. It was in the paper every day. Incompetence and Greed both are more one-week wonders, and sometimes less than that. Whether this affects the share price is hard to say, but on the next page, you can find the data for the first two weeks of July for our six contenders and the S&P500.

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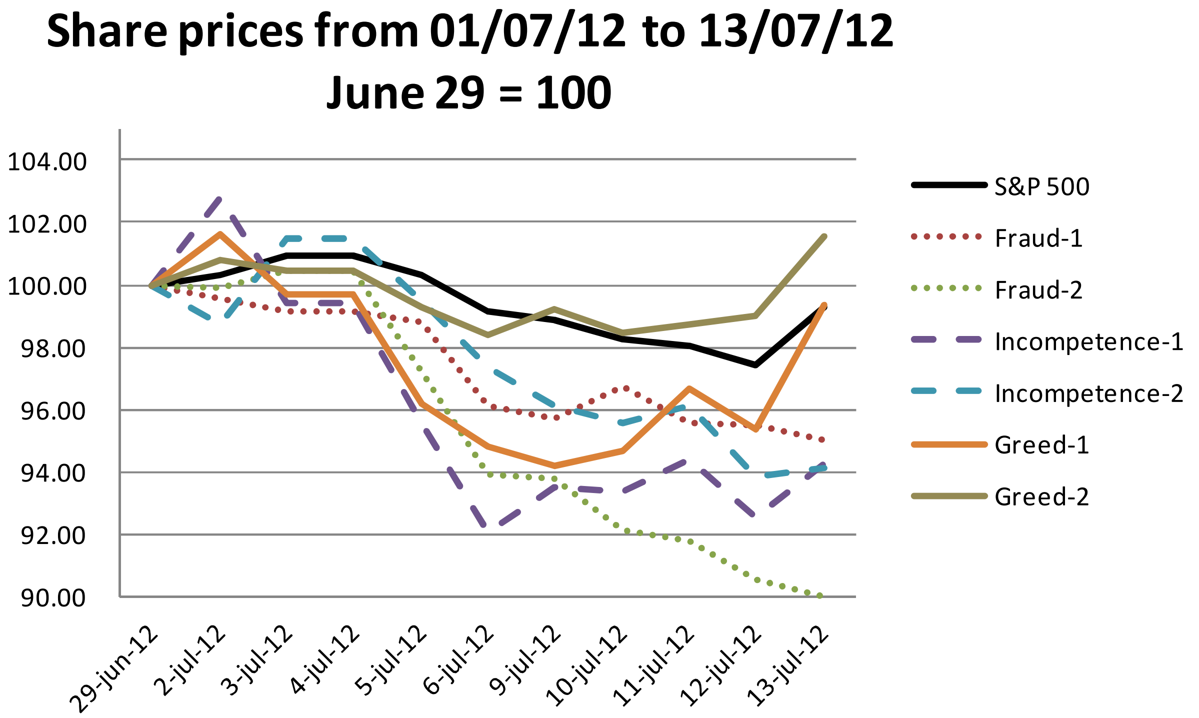

This diagram is of course not conclusive, and different benchmarks will give different results. But as far as a quick view can take us, the data does suggest that greed sometimes fares better, but by no means in all cases. It so happens that on July 13, our last day, the greedy banks outperformed the incompetent and fraudulent ones. In contrast, in the week before ending July 6, only one greedy bank did relatively better than the pack. It is worth noting, however, that throughout these two weeks, it was always an incompetent or a fraudulent which did worst of all. We will have to see again next year how they held up (if they are still around).

Conclusion
The total damage banks suffers from OpRisk events is hard to measure. But from this small sample, it would appear that events related to Fraud are punished harder than those related to Incompetence, and both are far more damaging to a bank than Greed-related events. Banks probably know this, since they have anti-fraud management units and training programmes, but no anti-greed policy. And thus, 25 years on, *Greed is **still** good*, even if it ends in disaster.