CORPORATE CORRUPTION AND THE NEW CHALLENGES FOR THE ROLE OF GOVERNMENT

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I. Introduction: the Scandals of Enron and Parmalat and the 2007 crisis

The US financial and economic distress that began in 2007 poses profound challenges for public policy and public administration in the US and abroad. Corporate mismanagement, insider trading in the stock market, reckless behaviour of accountants and auditors and conflicts of interest are at the heart of the problem.

The past experience of corporate scandals, such as the US company Enron, and the Italian company, Parmalat, and many other comparable scandals around the world has showed that information by private markets cannot always be trusted. Deficiencies in transparency, fairness, trust and freedom from corruption are very well seated in the corporate world, just as in government worldwide.

In 2001 the collapse of Enron revealed that some of the biggest financial institutions, both in the US and abroad, were creating products whose sole purpose was to help companies transform their debt into capital or revenue through the use of accounting loopholes, special purpose entities, and poor financial reporting. When energy regulations were softened, Enron[1] took advantage and gained rich profits and returns from a trading and risk-management business built essentially on assets owned by others. Bankers, stock analysts, auditors, and Enron's own board failed to comprehend the risks in this heavily leveraged trading giant. Several major banks provided large loans to the company without understanding, or while ignoring, the risks involved. It became the nation's largest bankruptcy case. Many executives at Enron were indicted for a variety of charges and were later sentenced to prison. As a consequence of the scandal, new rules were enacted in the USA to expand the reliability of accounting and financial reporting for public companies.

After two years from the collapse of Enron, Europe experienced its own corporate scandal that was, in terms of size and fraudulent behaviour, comparable to the US scandal. Parmalat, the Italian dairy and food household company, one of the country's few international

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[1] Enron was formed in 1985 by Kenneth Lay after merging Houston Natural Gas and InterNorth. Lay had a vision for Enron that went far beyond that of a traditional energy company. When Lay formed Enron from the merger of two pipeline companies in 1985, he understood that deregulation of the business would offer vast new opportunities. The innovative techniques used for energy trading were expanded into new arenas, everything from broadband to metals, steel, and even advertising time and space. Ex CEO Jeff Skilling's said in an interview, "In the old days, people worked for the assets. We've turned it around--what we've said is the assets work for the people."

businesses, collapsed in December 2003.[2] It was labelled "the European Enron". Despite the differences of economic and political environments in USA and Italy, Enron and Parmalat showed striking similarities. They both performed multi-billion dollar transactions around the world that misled the market and investors about the true value of the company and its share price.[3] Parmalat used dozens of offshore companies to report non-existent assets to offset its liabilities. It employed obscure borrowing practices, false accounting, and misleading reports to investors and regulators for over ten years to keep the company afloat, with the help of the company's auditors and foreign banks, including Citibank and Deutsche Bank. On top of that, Parmalat claimed to hold at Bank of America an account of 4bn Euros that then resulted to be false. The accountancy make-up showed that, just before its collapse, the company managed to report revenues of 7.5 billion as opposed to 14bn Euros of debt. Thousands of Italian shareholders, including many pensioners, lost their life savings in the debacle. Mr. Tanzi, found guilty of fraudulent bankruptcy and criminal conspiracy, was sentenced to 18 years in jail. Several other people involved in the Parmalat's fraudulent affairs were sentenced to jail. The Parmalat debacle prompted the Italian government to pass a decree to facilitate the reorganization of the company under an appointed administrator. In addition, a new legislation was enacted to improve corporate management and reduce conflicts of interest.

The collapse of Parmalat shocked the European and Italian corporate worlds. European investors could not understand how a fraud this large could have occurred and how it could have been undetected for so long. Questions were raised about the ability of the European regulators to oversee their global and increasingly financially sophisticated companies. In Europe, Italy and other countries enacted national legislation to improve their corporate governance systems.

Enron and other American firms, such as World Com[4], all employed fraudulent mechanisms in order to make the companies look healthier than they were. In Europe, Parmalat, Cirio, and others showed a similar pattern[5]. Ample literature has shown that World Com and

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[2] Parmalat, guided by Callisto Tanzi, started in 1960 as a relatively small family business later transformed into a global milk and food powerhouse selling its products in thirty countries (e.g. long-life milk, Archway biscuits and Pomi tomato paste. At the end of the 1980s, the Parmalat group started to sell shares to the public (the Tanzi family maintained the 51% of the property) and was listed in the Milan Stock-Exchange. It employed 4000 people in Italy and 36,000 worldwhile

[3] For Parmalat, see G. Franzini, *Il crac Parmalat*, Roma:Editori Riuniti, 2004; G. Rossi, *Il Conflitto Epidemico*, Milano: Adelphi 2003; G. Spinelli, *Giochi proibiti*, Milano: Bruno Mondadori, 2004. For Enron, see T. F. Sterling (ed.), *The Enron Scandal*, Nova Science Publisher, 2002; B. McLean and P. Elkin, *Smartest guys in the room: the Amazing Rise of the Scandalous Fall of Enron*, New York: Penguin Books, 2004; K. Eichenwald, *Conspiracy of Fools: a True Story*, Brodway Books, 2005.

[4] In 2002, the case of WorldCom distress was another example of shady accounting methods put in place to mask the declining financial condition of the corporation. The books falsely showed financial growth and profitability to increase the price of WorldCom's stocks. Here too, the scandal resulted in heavy convictions in 2005. Bernard Ebbers was found guilty of all charges and convicted on fraud, conspiracy and filing false documents with regulators. He was sentenced to 25 years in prison. Other former WorldCom officials were charged with criminal penalties in relation to the company's financial misstatements (securities fraud, conspiracy to commit securities fraud, and filing false statements). See, W. Pavlo Jr. and N. Weinberg, *Stolen Without A Gun: Confessions from inside history's biggest accounting fraud - the collapse of MCI Worldcom*, Eika: Encino (CA), 2007.

[5] Cirio was the food empire headed by Sergio Cragnotti. It was best known for its canned tomatoes and fruit juices. The food groups Parmalat and Cirio were linked. Both Tanzi and Cragnotti owned football clubs - Parma and Lazio respectively - and were each suspected of helping the other, sometimes by buying and selling players at rigged prices. Both family-owned firms used the same auditors, Deloitte and Grant Thornton, and both had close links to

Enron were not isolated cases. They have been the most striking cases that came to the surface. Despite the new legislation, Governments, regulatory authorities and monitoring agencies disregarded the enforcement and implementation.

In effect, something of a huge magnitude was bubbling underneath the financial world, ready to burst.[6] Eventually, it did blow out showing a systemic failure. The 2007 crisis, comparable to the one of 1929, blew out in the USA with serious repercussions worldwide. A systemic crisis showing a widespread greedy financial market dominated by reckless and irresponsible behaviours of a corporate world seeking short-term profits at the expense of the health of corporations and the society at large.

While the crisis was unfolding, in the USA, the Madoff scandal broke in 2008 when Bernard Lawerence Madoff, a New York financier (former chairman of the Nasdaq stock market) who orchestrated a $65 billion "Ponzi scheme" [7] was sentenced to prison. His firm, the Bernard Madoff Investment Securities, deceived investors, regulators and banks over the last 16 years. Madoff's Ponzi scheme was the largest in history. In Italy, the Lande scandal broke in 2010. As the administrator of the European Investment Management (EIM), Lande (a former Italian banker) created a network of unregistered foreign investment companies, mainly in off-shore territories and promised appealing returns on investments, over the past twenty years, to several clients in Rome by dodging local regulations and avoiding all kinds of monitoring and control. The huge scam is still under investigation and Lande is in prison.

At this point, simple questions are due. Why the previous experiences of corporate scandals, like the ones of Enron and Parmalat were not lessons to be learned? Why the situation deteriorated so badly?

Today, many argue that inconsistent government macroeconomic policies or moral hazard in the financial system caused by government guarantees is at the root of the recent crises. Others essentially blame the free market that failed under globalization and government deregulation. Market operators acted unethically, to say the least. They used obscure language in showing balance sheets, sold risky products without explaining the downside of them to the

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Cesare Geronzi, the chairman of the Banca di Roma (later Capitalia). Some of Italy's top bankers were suspected of helping discharge Cirio's rotten debt into the market by persuading the company to issue worthless bonds. A few months before Cirio's problems became apparent they repaid its debts to the Banca di Roma by draining more than €17m from the group's holding company. In exchange, the holding company - and Cirio's shareholders - were given worthless shares in a Luxembourg-registered business that no longer existed. It was declared bankrupt, having defaulted on more than €1bn worth of bonds in 2002. Put under administration by the courts, it was given a year to sell its assets.

Cragnotti was arrested with his son, Andrea, and son-in-law, Filippo Fucile, both executives of the group. Many others were sentenced. Another scandal which is worth mentioning is the Vivendi Universal company, the French media giant, with Jean-Marie Messier as CEO were accused of frauds and false statements about the company's finances between 2000 and 2002, before a collapse of the group's share price.

[6] After the fall of Lehman Brothers in 2008, it was discovered that it had performed bookkeeping scans known as "Repo 105". Lehman disguised its growing debt until it collapsed. It got new loans to pay off old loans and showed the new loans as "sales". And through a complicated process made the old and new loans disappear just before its quarterly report. The Security Exchange Commission was Lehman regulator, but nothing came to the surface. The Fed, the Treasury, the Office of the Comptroller of the Currency, the Office of the Thrift Supervision did not expect the collapse of Lehman.

[7] A Ponzi scheme is a fraud which involves paying old investors with funds from new ones.

buyer, focused only on short-term profits and high fees, bet on and prospered from a system that it is bound to fail with the consequence that all taxpayer would have to pay the price of the failure. In any case, the general conclusion was that Governments relied too much on the private market.[8] The response has been government intervention to rescue the economy and prevent crisis of this entity in the future. Regulation has been the primary solution. Is regulation the best response?

The purpose of this paper is to focus on the systemic unethical or corruptive behaviour in the private sector and find an answer to those questions. First, Enron in the USA and Parmalat in Italy are compared, also in terms of government's response to the scandals. Then, the 2007 crisis is examined in order to find out similarities and differences with regard to the previous scandals and will discuss on why things got worse. This paper examines the measures that both the Governments of USA and Europe have put in place so far and those that are under discussion. Are those measures conducive to prevent and contain the unethical, corruptive, and criminal behaviours that are so pervasive in the private sector? What else should be done to restore the value of doing business with integrity and fairness? The paper concludes that culture plays a pivotal role in this issue. Governments, corporations, and civil society could cooperate to spread the culture of integrity.

II. Enron and Parmalat Compared

Enron and Parmalat scandals were very similar in the magnitude of fraudulent financial transactions. However, both played in different economic and regulatory environments, and in different cultures.

First of all, continental Europe has traditionally relied on tight regulations and State protectionist power as opposed to the US fundamental belief in private risk taking and competition. The US has been a free market, individual entrepreneurial society from its birth. The principles of classical economic theory imported from England fit very well in the social, political, and economic context of the country. Adam Smith as well as Thomas Jefferson, James Madison and Alexander Hamilton had many points of disagreement, but all believed in the benefits of a capitalist development and the role of private enterprise. Adam Smith argued that the mercantile State (which extended from 1500 through the 1700s) based on government and businesses interconnections for territorial expansion, trade, wealth, and power had created a situation of widespread corruption and continuous warfare, holding back private enterprises. In its place, a laissez-fare State was necessary for capitalism to develop. In the continental Europe, the Roman heritage and the Napoleonic influence encouraged the growth of the State and of codified separated branches of law related to public and private spheres. The principle of separation of powers (Montesquieu) was intended to ensure the proper functioning of the State and the preservation of the liberty of the people depended on the good organization of the State. Capitalism developed under the direction and control of the State. The Italian experience of the "State participation system" (that started under fascism and lasted for more than fifty years, operating in crucial sectors of the economy, like gas, oil, energy, chemicals) became a model in post WWII Europe. Only in the mid-1980s, under globalization and the pressure of the European integration that called for a progressive abandonment of State-protectionist measures and a significant reduction of budget deficits, State intervention started to decline in favour of private

[8] J. E. Stiglitz, Free *Fall: America, free Markets, and the Sinking of the World Economy*, Norton: New York, 2010.

enterprises in USA and Europe. In Italy, however, only a few large private corporations have been created.[9] For historical and geographical reasons, the production structure of the country has always been small-scaled and geographically segmented.[10] Small enterprises have always been the motor engine of national production. They are mainly concentrated in the North, where public infrastructure is mostly developed. However, under the current globalized trade dominated by giant enterprises, the Italian small enterprises have been facing enormous competitive problems. In Italy, capital is limited (the so called capitalism without capital) because national private equity is low and foreign injection of capital is limited. The major souce of capital come from the banking sector. The big Italian companies maintain a complex and intricate sytem of national cross participations characterized by personal relationships and a web of exchange of favours both in the political and banking spheres. Most of them are family businesses,[11] which, except in a few cases, remain anchored to the national narrow environment by enjoying the clienteles of the sponsoring entourage. The interaction of several diversified interests often conflicts with the strategic objectives of the companies involved deteriorating the health of the same companies and the economy at large. Another relevant negative element that characterizes the Italian political and economic environment is the strong power of organized crime. The Mafia in Sicily, the Camorra in Naples and the N'drangheta in Calabria have ramifications in all parts of the country conducting illegal activities in all sorts of major economic sectors, often with the blessing of political representatives. As a result, the correct functioning of the market is impeded and the country's economic development is damaged.

Another point of comparison concerns lobbying activities. Lobbying is inherent in capitalistic democracies. In the USA, lobbying is viewed as an element of democracy. Businesses are entitled to be heard in the democratic decision-making process, and lobbying conveys important information and opinion to political representatives and public officials for a better decision-making process. There is a risk, however, that powerful private sector players capture policies and governments and threaten democratic decisions.[12]. The 'capture' of lawmakers and government officials produces mistrust in politics and democracy. Political patronage and cronyism deprive citizens of their country's wealth. TI's Global Corruption Barometer constantly shows that parliaments and political parties are perceived to be the two most corrupt institutions in society.[13]

Both Enron and Parmalat used globalization to their advantage and, in order to shield the negative effects of this phenomenon (currency fluctuations, for example), used numerous

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[9] Some of them, like Parmalat, grew significantly and expanded abroad over the years thanks to the alliance with the national bank sector and the favour of politicians. Others, like Luxottica and Benetton have become successful global players by competing with dynamism and fairness.

[10] In Italy family businesses are 90 % of the firms which employ 75% of labour. In USA family businesses are 96 % and employ half of the total labour.

[11] A. Colli, *Capitalismo familiare,* Bologna: Il Mulino, 2006.

[12] In the United States, lobbying expenses have almost doubled over the last decade, reaching US$2.8 billion in 2007 and swelling the ranks of lobbyists to a record 16,000 in 2008. In Brussels an estimated 2,500 lobbying organizations with 15,000 lobbyists exercise influence on EU policy-making. See W.Lehmannand and L.Bosche, "Lobbying in the European Union: Current Rules and Practices," WorkingPaper no.04-2003. (Brussels: Directorate-General for Research, European Commission, 2003).

[13] Transparency International, *Global Corruption Barometer 2007.*

affiliates and subsidiaries ("special purpose entities" in Enron case), to hide the company's debt. Enron also employed sophisticated exotic derivatives worldwide. If one looks closely, the fraudulent methods adopted by Parmalat were much less sophisticated that those of Enron. Parmalat relied essentially on a local accountant, profoundly loyal to the family, who performed ordinary types of frauds, such as "cut and paste" in falsifying accounting documents and even a forgery of a letter that invented 4.9 billion dollars deposited at Bank of America. Enron recruited a large number of fresh MBAs each year from the nation's top business schools who helped analyse and model the vast amounts of data that Enron used in its trading operations. The wrong doing, however, pointed to the same illegal objective: cover the large debt of the company.

In both in Enron and Parmalat, the executive remuneration was not linked to the medium-term performance of the companies in the interests of the shareholders, but to the short term investment returns in the interest of the executives themselves. However, in Enron, the use of stock options as a means of remuneration has contributed to an excessive expansion in executive compensation. In USA, the practice of equity-based pay has been welcomed as a means to align the interests of management more closely with overall corporate performance. Enron, however, used stock options as a device to perpetrate fraud. At one point, stock options accounted for almost 13 per cent of Enron's total voting capital, providing a strong incentive for their owners to manipulate earnings and revenues. In Europe, the phenomenon of excessive executive remuneration is less visible.

A further piece of evidence involves both Parmalat and Enron's accounting and auditing practices: they were at odds with international standards. The auditor's responsibility for audits of subsidiaries conducted by other firms in offshore tax haven territories was completely obscured. That resulted in lack of transparency and conflict of interest.

III. Government Response in USA and Italy

In both the USA and Italy, government responded to the scandal with new regulations directed to restore the investor's confidence in accurate, reliable financial statements of private companies. Their common objectives were: 1) to reinforce corporate governance, 2) to limit conflict of interest, 3) to enhance accountability, 4) to increase the number and the severity of criminal and civil penalties.

In the USA the *Public Accounting Reform and Investor Protection Act of 2002 (the Sarbanes-Oxley Act- SOX)* was approved. It established *the Public Company Accounting Oversight Board*, to provide independent and effective oversight of external auditors; to dictate standards for external auditor independence, to limit conflicts of interest; to expand and increase criminal penalties for destroying, altering, or fabricating records to mislead federal investigations or to defraud shareholders; to mandate that Chief Financial Officers (CFO), in conjunction with CEO take *individual responsibility* for the accuracy and completeness of corporate financial reports. The CFO aquired a wide range of administrative, financial and control responsibilities. The same law enumerated specific limits on the behaviors of corporate officers and described specific forfeitures of benefits and civil penalties for non-compliance; enhanced reporting requirements for financial transactions, including off-balance-sheet transactions. It required

codes of conduct for securities analysts and disclosure of knowable conflicts of interest.[14] Since SOX was passed, pressure has been brought to bear on companies in many countries to separate the jobs of CEO and chairman, and to include more non-executive and independent members on boards to tackle conflicts of interest related to internal controls, financial reporting and executive nomination and compensation.

In Italy, government response followed a similar regulatory pattern with the enactment of the Law No. 262/2005 which dictated new rules for the reinforcement of internal and external audits. The *Dirigente preposto alla redazione dei documenti contabili* holds approximately the same responsibilities of the CFO in the SOX. In addition the Italian legislation takes care of the expansion of the regulatory power of the CONSOB (the Italian Security and Exchange Commission-SEC), the increase of penalties for criminal and civil offences, the issues of conflict of interest and lack of transparency connected to off shore finance centers have been particularly addressed by dictating specific counteracting rules.

Numerous studies have been conducted to analyze the impact of the new rules. It was found that the quality of corporate governance had improved in many countries. The United States is widely believed to have led the way. In a sample of more than 7,500 companies in twenty-three developed countries, only 8 per cent of non-US companies exhibited better corporate governance characteristics than comparable US companies.[15] Overall, investor's confidence in financial reporting was enhanced.[16] However, other studies concluded that the US rules were too strict causing a shift of the number of initial Public Offering (IPOs) from the American Stock exchange to the London Stock Exchange.[17] A December 21, 2008 Wall St. Journal editorial stated, "The new laws and regulations have neither prevented frauds nor instituted fairness. But they have managed to kill the creation of new public companies in the U.S., cripple the venture capital business, and damage entrepreneurship."

The effectiveness of tighter regulatory measures has been widely questioned, especially after the 2007 collapse of the financial market in the USA. When the 2007 crisis blew out, the trust on the US market, that the law intended to reinforce, collapsed completely

IV. The 2007 crisis

In the US, as early as 2004, mortgages were offered to a growing number of subprime borrowers (those with the weakest credit). This was done under the blessing of Federal Government action that softened the regulations of the Community Investment Act of 1977 (CRA). Fannie Mae and Freddie Mac were encouraged to expand the housing market.[18] Many

[14] In addition the *Global Legal Settlement signed in 2002* between the SEC the New York General Prosecutor and ten major investment banks aimed at improving the quality of information provided by financial markets and limiting conflict of interest in the banking sector.

[15] R. Aggarwal, I. Erel, R. Stulz and R. Williamson, Do US Firms Have the Best Corporate Governance?, Working Paper no. 145/2007 (Brussels: European Corporate Governance Institute, 2007).

[16] The FEI 2007 study and research by the Institute of Internal Auditors (IIA)

[17] J. Piotroski and S. Srinivasan, "Regulation and Bonding: Sarbanes Oxley Act and the Flow of International Listings" in the Journal of Accounting Research in 2008.

[18] This started in 1999 when Fannie Mae, under the pressure of the Clinton administration, expanded loans to low and moderate-income borrowers by softening the restrictions of the Community Reinvestment Act of 1977 (CRA) designed to boost lending in distressed inner cities areas. The act forced local banks to open new branches in these

lenders expanded their lending and sold these risky loans mostly to Wall Street to be packaged into mortgage-backed securities, thus passing along most of the risk. The lenders were concerned more with the quantity of mortgages they sold than with their quality. They did not care since they were selling the loans immediately and earning big fees. The packaging by Wall Street firms became more and more complicated and risky. Many investment banks were carried out by the euphoria of mortgage-backed securities trading and conducted a reckless behaviour.

In 2004-2006 the regulatory agencies issued statements on these practices that were so complex that they disguised the law evasion. These practices showed "lack economic or business purpose" and were "designed or used primarily for questionable accounting, regulatory or tax objectives, particularly when the transactions are executed at year end or at the end of the reporting period.

Many operators were not aware of the damage they were doing. [19] But, some were aware that the financial system was about to fall. They realized that the financial sector was overloaded by bad loans and they started betting against these products thereby getting profits (betting on the falling price).[20] They also took advantage of the expansion of Credit Default Swaps (CDS), a form of insurance against these risky Wall Street instruments. When loans and bonds went bad, the CDS holder could cash the insurance. There was a big incentive to buy insurance, since the

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areas and to have a certain percentage of their lending portfolio of small business loans and home mortgages located in these areas. Failure to maintain this ratio would result in the banks being prevented from opening branches in other areas that were not distressed. In 1999, Fannie Mae, under the Clinton Administration expanded mortgage loans to low and moderate-income borrowers by increasing the ratios of their loan portfolios in distressed inner city areas designated in the CRA of 1977. Because of the increased ratio requirements, institutions in the primary mortgage market pressed Fannie Mae to ease credit requirements on the mortgages it was willing to purchase, enabling them to make loans to subprime borrowers at interest rates higher than conventional loans. Shareholders also pressured Fannie Mae to maintain its record profits. In 2000, anti-predatory lending rules were put into place that disallowed risky, high-cost loans from being credited toward affordable housing goals. Later on these restrictions were released. In 2002, President George W. Bush signed the Single-Family Affordable Housing Tax Credit Act. Dubbed "Renewing the Dream," the program would give nearly $2.4 billion in tax credits over the next five years to investors and builders who develop affordable single-family housing in distressed areas. On September 10, 2003, the Bush Administration recommended the most significant regulatory overhaul in the housing finance industry since the savings and loan crisis. Under the plan, a new agency would be created within the Treasury Department to assume supervision of Fannie Mae. The new agency would have the authority, which now rests with Congress, to set capital-reserve requirements for the company and to determine whether the company is adequately managing the risks of its portfolios. On December 16, 2003, President George W. Bush signed the American Dream Down payment Act, a new program that provided grants to help home buyers with down payment and closing costs. The act authorized $200 million dollars per year for the program for fiscal years 2004-2007. President Bush also tripled the funding for organizations like Habitat for Humanity that help families help themselves become homeowners through 'sweat equity' and volunteerism in their communities. Substantially increasing, by at least $440 billion, the financial commitment made by the government-sponsored enterprises involved in the secondary mortgage market specifically targeted toward the minority market (see A. R. Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis—and Themselves*, Viking Press (USA) 2009). D. W. Conklin and D. Cadieux, *The 2007-2008 Financial Crisis: Causes, Impacts and the Need for New Regulation,* Boston:Harward Business Press, 2008.

[19] An interesting explanation is given by Robert J. Shiller, *Irrational Exuberance*, New York: Broadway Books, 2005.

[20] M. Lewis, *The Big Short. Inside the doomsday Machine*, New York- London: Norton & Company, 2010.

CDS volume could be unlimited. Now, analysts recognize that the large expansion of CDS should have alarmed the investors that things were going bad.

The first manifestations of the crisis were the failure of Bear Stearns, the Federal takeover of Fannie Mae and Freddie Mac, the failures of the Investment banks Lehman Brothers and AIG, the troubled situation of Citigroup and Bank of America. [21]

In the years before the collapse, Lehman used a small firm, called Hudson Castle, to move its business off the books in order to obscure its financial condition before it plunged into bankruptcy. Hudson Castle acted behind the scenes of Wall Street, largely beyond the reach of banking of regulators. Lehman owned a quarter of the firm. These entities enable banks to exchange investments for cash to finance their operations and, at times, make finances look stronger than they are. These are borrowing tactics used to allow the banks to temporarily transfer their risky investments tied to subprime mortgages and commercial real estate. Most tactics were legal, many were not.

V. Government Responses to the Crisis

Both government and markets have been blamed for the damage caused by the crisis. Academics and experts have pointed to various causes. [22]

First, the ever-growing advance of technology has expanded commercial trade both in number and in type of products. Technological capability, especially in the USA, allowed Enron to create a rapidly growing business of electronically matching buyers and sellers of numerous commodities. Over the years, technology facilitated the creation of innovative financial products that became too complex for many people to understand. In fact, many big financial institutions were found with excess of leverage and a massive amount of risk on their books. One of the lessons of the Internet boom is that it's often difficult for analysts to understand and evaluate new kinds of products and trading and the risks involved. Market assessments can be dramatically wrong. The crisis was a consequence of a serious under pricing of the risk of subprime mortgages and securities of various sort issued against that paper.[23] Financial institutions have developed sophisticated models for assessing the risks associated with the extension of credit. Yet, sophisticated efforts to monitor risk did not deliver the expected results.

Second, inconsistent government policies took place in the USA and elsewhere. In USA, the repeal in 1999 of the Glass-Steagall Act, which had separated investment banks from commercial banks, allowed the creation of bank-mergers thereby giving rise to large institutions that became “too big to fail”. By 2004, many US banks had abandoned the “credit model” aimed at lending to small and medium-size enterprises (SME) and individuals and focused on a model based on the capital market. With the growth of the housing market under the encouragement of government that released some of the restrictions imposed by the regulations of the Community

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[21] The New York Times April 13, 2010 by Louise Story and Eric Dash.

[22] Besides the numerous articles and books, see National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis. Inquiry Report*. Public Affairs: New York 2011.

[23] W. Poole, “Moral Hazard: The Long-Lasting Legacy of Bailouts,” *Financial Analyst Journal*, Vol. 65, n. 6, 2009, 17-23.

Reinvestment Act of 1977,[24] they expanded the flow of loans to subprime borrowers and packaged these loans into complex financial products to be sold to the capital market

The dual goal of expanding home-ownership and relying on the market contributed to the crisis. In Europe, the excessive expansion of private debt on top of inconsistent fiscal policies pushed some countries like Ireland, Portugal and Spain to the edge of bankruptcy. The crisis hit harder in Greece where budget choices were irresponsible and budget documents resulted in manipulation to cover huge deficits.

Third, monetary policy was expansive. All over the world, big investors took advantage of the low cost of capital and used arbitrage opportunities in earning up-front fees and profit growths while long-run risks were shifted to others.

Fourth, the reckless lending behaviour and the focus of short-term returns based on risky products occurred in absence of an effective oversight and control. Executive remuneration and its misalignment with long-term performance have encouraged excessive risk-taking that prepared the ground for the crisis.

Fifth, lack of transparency was largely present. Lehman Brothers and others used to channel risks through shadow companies unknown to the bank's investors. These companies were mentioned only in the footnotes of the financial statements, or not at all. How can the auditors perform their job if these off-balance sheet instruments are concealed?

Six, internal checks and balances were not effective. Asset misappropriations and accounting frauds were not reported in many cases of detected economic crimes. Monitoring progress and verifying corporate disclosure was not widespread either. In a recent survey of Transparency International, almost 90 per cent of the top 200 businesses worldwide have adopted business codes, but fewer than half reported that they monitor compliance. In addition, a large number of executives admitted to not being familiar with important legal frameworks in global business, the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. Training programs for executives on how to avoid corruption were scarcely used.

Seven, conflict of interest was widespread. While new complicated financial products and creative borrowing tactics were created to help companies, cities, and countries hide their true financial condition, auditors performed their job in a careless manner. In addition, the credit rating agencies were paid to issue good marks, which did not correspond to the true financial shape of the institutions. Persistent conflicts of interest for accountants, auditors, and rating

[24] *The Community Reinvestment Act* was intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighbourhoods, consistent with safe and sound banking operations. It was enacted by the Congress in 1977 (12 U.S.C. 2901) and is implemented by Regulations 12 CFR parts 25, 228, 345, and 563e. The CRA requires that each insured depository institution's record in helping meet the credit needs of its entire community be evaluated periodically. That record is taken into account in considering an institution's application for deposit facilities, including mergers and acquisitions. CRA examinations (see Exam Schedules) are conducted by the federal agencies that are responsible for supervising depository institutions: the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

agencies have been identified as a major issue for corporate integrity and an important factor in the financial crisis.[25]

To counteract the above loopholes, a wide range of measures taken by governments and regulatory authorities have been trying to strike a balance between corporate self-discipline and government intervention. Improving regulation, and enhancing oversight and control over implementation have been the major response to the crisis. [26]

Government intervention has been massive around the world to avoid a financial and economic catastrophe. Meanwhile, at global level, the *Financial Stability Board (FSB)*, [27] coordinated by the Governor of the Bank of Italy, Mario Draghi, has worked multilaterally to set new rules for the financial sector (Basil III) in order to check the solidity of the system and avoid the occurrence of future systemic crisis approved by the G20 meeting held in Seoul, ROK on 11 and 12 November 2010.

At the national level, the US and many other countries responded by adopting bailout measures in favour of financial institutions, which were too big to fail. Government budget deficits and public debt levels in the US and in Europe have expanded enormously. Most of the burden has been on the back of the taxpayers. The gains have been privatized and the losses socialized. The impact of a large-scale misconduct in the financial world has been devastating.

a) In USA

Government intervention to provide financial resources came first. *The Emergency Economic Stabilization Act of 2008* in October 2008 gave the Treasury the resources and the authority to put public money into foreclosure avoidance. In addition, the *Trouble Assets Relief Program (TARP)* provided the Treasury with *$* 700 billion fund to purchase illiquid assets from banks in order to reduce uncertainty about financial institutions' viability and restore market confidence. Despite these measures, the market continued to deteriorate. As a result, in the US the Treasury shifted from assets purchases to capital injections directly into banks. These capital injections compounded with a Federal Deposit Insurance Corporation (FDIC) program directed to guarantee bank debt, brought a perception of a resumed level of stability in the financial sector. The Treasury and the FED jointly provided additional capital and insurance (with non recourse financing) for some of the assets of Citigroup and Bank of America.[28]. On top of that,

[25] J. C. Coffee Jr., *Understanding Enron: It's about the Gatekeepers, Stupid*, Working Paper no. 207 (New York: Columbia Law School, 2002); S. Di Castri and F.Benedetto, *There Is Something about Parmalat (On Directors and Gatekeepers)*, working paper, 2005 (available at SSRN:http://ssrn.com/abstract=896940); J. C. Coffee Jr., *Gatekeeper Failure and Reform: The Challenges of Fashioning Relevant Reforms*, Working Paper no. 237(New York: Columbia Law School, 2003); OECD, *Enforcement of Corporate Governance in Asia: The Unfi nished Agenda* (Paris: OECD, 2008); E. B. Smith, 'Race to Bottom at Moody's, S&P Secured Subprime's Boom, Bust', Bloomberg, 25 September 2008.

[26] **D. W. Conklin and D. Cadieux, The 2007-2008 Financial Crisis: Causes, Impacts and the Need for New Regulations, Boston: Harward Business Press, 2008.**

[27] The FSB was established by the G20 member States after the experience of the Financial Stability Forum (FSF) (initiated in 1999 by the G7 countries). It is an international entity entrusted to evaluate the vulnerability of financial markets and create a regulatory system for financial stability (www.financialstabilityboard.org).

[28] Providing insurance with non-recourse financing is economically similar to buying assets, but is much less transparent that either assets purchases or capital injections, and therefore politically preferable as a means of

the *Recovery and Reinvestment Act of 2009* (*Stimulus Package*[29]) provided $787 billion to over 160,000 entities (states, localities, non-profits): $288 billion in tax benefits, $275 billion in contracts, grants and loans, $224 billion in entitlements. The major regulatory reform was approved with *the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Public Law No: 111-203) directed to improve the transparency and efficiency of the financial markets. Above all, a new entity called *Systemic Risk Regulator* was established to identify and correct situations of systemic risks. New mechanisms have been created to prevent "too big to fail" institutions. Particular attention has been dedicated to the consumer's protection against the negative effects of banking and non-banking failures. To this end, an independent entity, the *Consumer Financial Protection Bureau*, was established.

b) In Europe and Italy

In Europe as well, member States intervened with a large injection of financial resources to save numerous financial institutions. When, Greece's public finance was found on the edge of collapse, the European Union (EU), in order to preserve the stability of the Euro system, created an emergency fund, the *European Financial Stability Facility* (EFSF) to extend loans and guarantees to this country (and later on to Ireland and Portugal) The European System of Central Banks (ESCB) provided additional capital to the system.

Regulatory reform came with the creation of the *European Systemic Risk Board (ESRB) and the European Supervisory Authorities (ESAs*), *to* prevent the occurrence of future systemic risks in the financial sector by monitoring the financial markets within the Union. In addition, new EU legislation is being approved in order to improve the European economic governance by coordinating national economic policies of the Member States and reinforcing the restrictions and the sanctions of the budget discipline of the Eurozone countries (*Stability and Growth Pact*). Each Member State has been adopting restrictive measures to reduce public deficits and debt.

Italy has resisted the violence of the crisis thanks to its sound banking sector and the fair condition of its public finances. The overly sophisticated creative finance instruments, widely used in the USA and United Kingdom, did not attract as many Italian investors. The problems for Italy are low productivity and weak economic growth due to the economic disparity between North and South, poor endowment of infrastructures, rigid labour market, and inefficiency of the tax system and public administration.

VI. New Challenges for the Role of Governments and the Private sector in the US and Europe: Implications for Corruption

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providing subsidies to financial market participants. P. Swagel, "The Financial Crisis: An Inside View," Washington DC: *Brookings Papers on Economic Activity*, Spring 2009, 1-63.

[29] Obama's Performance Revolution presents a shift from a traditional performance model organized around agencies and programs to one premised on a series of services and results. The czars around the cross-cutting outcomes (e.g. climate change) are the application of new roles and responsibilities reaching across agency boundaries (a stealth revolution). FY 2011 budget: "Government operate more effectively when it focuses on outcomes, when leaders set clear and measurable goals, and when agencies use measurement to reinforce priorities, motivate action, and illuminate a path to improvement".

A vast reform movement is underway to sanitize the market place, encourage the restoration of an ethical and professional behaviour in the business place, and the development of antibodies against fraud and corruption. An enormous damage has been done by the excess of risk-taking behaviour in the private market place without appropriate and effective supervision. Many people were carried away by enjoying the perverse benefits, while others who were careful and responsible, and conservative in their decisions, have been suffering a lot from the consequences of mistakes of which they were not a part. Public outrage over bonuses and corporate perks is widespread.

Regulation is important, but other measures are needed to encourage the private sector towards voluntary initiatives that promote professional behavior and discourage corruption.[30]

Corruption is defined by Transparency International as 'the abuse of entrusted power for private gain'. "For business, this means more than the perceived need to bribe public officials.

Corruption risks inside the enterprise include, among many others, corporate fraud, manipulating accounts and insider trading. Corruption in dealing with customers and suppliers can take the classic form of kickbacks to public officials, but it also includes, for example, the bribing of purchase officers to win business at other companies' expense (commercial bribery). In the wider market environment, entrusted power can be abused to collude with competitors or form cartels, hurting markets and consumers. At the societal level, corporate power can be abused to dodge laws and regulatory oversight, or exercise undue influence on regulations and policy-making, with implications for foreign direct investment, global supply chain integrity and transnational taxation."[31]

Transparency International's Global Corruption Report 2009 shows the crucial importance that corporate shareholders and all stakeholders (owners, investors, workers, financial intermediaries and auditors, the media, citizens as consumers and civil society at large) join business executives and regulators in combating corruption in business. The key is the formation of *corporate integrity systems* which enhance the transparency and accountability of businesses while providing checks and balances and proper incentives. Strengthen international cooperation between regulators is central. Addressing corruption in global business requires a global approach, involving cooperation across borders for anti-corruption agencies, the competition and tax authorities and financial market regulators.[32]

A wide range of research has evolved around the values of regulation, transparency, corporate and civil society's responsibility. It is the corporate integrity culture that needs to be built in the new global environment.

1. *Regulation*

There is a wide literature on regulation that attempts to respond to the following questions: Is regulation the solution? Is there a risk of excessive regulation? Or should the focus

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[30] For a wide discussion on the economics of corruption, S. Rose-Ackerman (ed.), *International Handbook on the Economics of Corruption.* London: Edwar Elgar Publishing Limited 2006.

[31] Transparency International, *The Global Corruption Report 2009.*

[32] For an ample discussion on corporate integrity system, see Transparency International Annual Report 2009.

See also Centre for Business and Professional Ethics, *Global and Local Anti-corruption Initi*ative, University of Pretoria, 2009. See http://web.up.ac.za/sitefiles/file/46/5232/GACI%282%29.pdf

be shifted to designing incentives that enable market forces to lead firms, or force them, to pursue less risky strategies? Do we really need new laws after deregulation? Wouldn't it be safe to implement existing laws? Once we have established that regulations are provided for the purpose, the question is whether there are sufficient resources to implement and enforce them. Regulations might be a solution if the authority and financial resources are there to implement and enforce them. An additional question is due: do we want to empower consumers (give them more legal power) in monitoring law enforcement or we leave it to public authorities or both?

Numerous studies have shown that it is not the intensity of penalties that produces results, rather the enforcement (and monitoring) of the penalties. For sure, implementation needs to be reinforced. In this regard, the efficiency of the judicial system is also important. When the action of magistrates is slow, the process expires or the judgment comes too late to ensure a just remedy.

Empirical findings highlight the fact that enforcement intensity and style can and do vary widely between countries, and that these dimensions of enforcement need to be taken into account when assessing the efficacy and impact of particular laws and regulations. [33]

2. *Transparency*

It is also important to increase transparency for the proper monitoring of law enforcement, to uncover or prevent fraud and ensure that government funded relief measures are managed according to government objectives.

In USA, the *Recovery and Investment Act of 2009* (RIA) is an example of enhancing transparency of both spending and performance data. The Recovery Accountability and Transparency Board has been instituted as a watchdog for the American public on the use of Recovery Act funds. The Board, which includes 12 federal Inspectors General from various government agencies, has two principal goals: to prevent and detect waste, fraud and mismanagement, and to provide the American people with extraordinary transparency on how Recovery Act funds are being used by states, local governments, and private recipients. To provide the public with accurate, user-friendly information the Board also maintains a website named Recovery.gov, which provides information on agency plans and programs and disbursements around the country. The Board issues quarterly and annual reports on its oversight findings and provide advice to government agencies. When a matter requires immediate attention, the Board sends "flash reports" to the President and Congress. In addition, the OMB

[33] For a discussion on regulation, T. Tyler, *Why People Obey the Law* (New Haven, CT: Yale University Press, 1990; Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate,* New York: Oxford University Press, 1991;C. Coffee, Jr., 'Lawand the Market: The Impact of Enforcement', University of Pennsylvania Law Review, vol. 156, no. 2 (2007); N. Gunningham, R. Kagan and D. Thornton, *Shades of Green: Business, Regulation, and Environment* Stanford, CA:Stanford University Press, 2003;OECD, *Enforcement of Corporate Governance in Asia: The Unfi nishedAgenda,* Paris: OECD, 2008. R. Chari, G. Murphy and J. Hogan, 'Regulating Lobbyists: A Comparative Analysis of the United States, Canada, Germany and the European Union', *Political Quarterly*, vol. 78, no. 3 (2007); T. L. Dickinson and V. Khanna, 'The Corporate Monitor: The New Corporate Czar?', *Michigan Law Review*, vol. 105, 2007; C. Ford and D. Hess, 'Can Corporate Monitorships Improve Corporate Compliance?', *Journal of Corporate Law Studies*, vol. 34, no. 3, 2010.

Watch[34] and the Coalition of Accountable Recovery (CAR)[35] provide the public with data on the use of funds under the RIA.

Business should do its part. In order to provide meaningful transparency, business should adopt, support and actively engage in the development of standardized methods and procedures for proper reporting.

3. Corporate Responsibility and Citizenship

Corporate Responsibility System (CRS) is conceived as a voluntary contribution to sustainable development[36]. Europeans move from hierarchical state regulation to societal co-regulation through networks that bring state and non-state actors closer together. Many European governments have assumed an increasing role in shaping and promoting CRS as a complementary to hard-law regulations. CRS pushes companies to integrate anticorruption measures as a means of protecting their reputations, and to communicate effectively their corporate responsibility activities to the public (they have to make all commitments binding, verifiable and open to monitors of compliance).

Today a growing number of investment managers are looking closely at internal controls related to business ethics and corporate integrity as evidence of good business practices and sound management. Employees are found to play a pivotal role in ensuring corporate integrity. They can provide an early warning system (whistleblower) for shortcomings in supply chain integrity, corporate governance structures and business culture or for corrupt business practices. Empowering workers to become drivers for corporate integrity requires strong provisions for legal protection, as well as sincere commitments by companies to establish effective complaints and whistleblower systems and align human resource management with incentives for ethical behavior.

4. Civil Society's Responsibility

Civil society can help the State to design appropriate strategies, enroll the participation of citizens and enterprises in implementing anti-corruption measures and maintain social pressure for continued political commitment to tackle corruption. Civil society coalitions play an essential role in being credible catalysts of multi-stakeholder action and in providing societal control on business and combat corruption on all its forms. Technology is an effective mean to achieve this end. In the USA, the Coalition of Accountable Recover (CAR) is active in controlling and communicating to the public the use of public funds under the RIA.

5. *Culture*

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[34] OMB Watch is a nonprofit research and advocacy organization, formed in 1983 to bring sunshine to the White House Office of Management and Budget (OMB).

[35] The Coalition for Accountable Recovery was created after TARP (and while Congress was debating the massive stimulus bill) to promote accountability for both federal government agencies doling out the trillions of dollars, for the states and for the companies that benefit from recovery funds.

[36] R. Steurer, The Role of Government in Corporate Social Responsibility. Characterising Public Policies on CSR in Europe, *Policy Science,* vol.43, No.1, 2010, 49-72. L. S. Paine, *Value Shift: Why Companies Must Merge Social and Financial Imperatives to Achieve Superior Performance,*New York: McGraw-Hill, 2003. L. S. Paine, *Value Shift: Why Companies Must Merge Social and Financial Imperatives to Achieve Superior Performance,* New York: McGraw-Hill, 2003.

The role of education is a fundamental for the creation of a culture of integrity, fairness, and trust in government, business and society. Schools, colleges and universities must share the task of educating people to live in a healthy and just society (MBA programs in particular). Families and schools have the responsibility to instill shared principles and value for the common good of the entire society.

In business, the fundamental task of the CEO is to create the "performance with integrity culture,'"both to avoid catastrophic integrity misses and to create affirmative benefits inside the company, in the marketplace and in the broader global society. That culture entails shared principles (values, policies and attitudes) and shared practices (norms, systems and processes). "[37] According to this line of thought, the culture of fundamental integrity must be uniform and global and follow eight core principles for "high performance with high integrity": [38]

> "a) committed and consistent leadership that makes performance with integrity the foundation of the corporation;
>
> b) managing performance with integrity as a business process by building the integrity infra-structure (risk assessment and risk abatement to prevent, detect and respond) into business operations;
>
> c) adopting global ethical standards beyond what the law requires (e.g. no bribery in either public or private sectors anywhere);
>
> d) using early warning systems to stay ahead of global trends and expectations;
>
> e) fostering employee awareness, knowledge and commitment through stimulating, systematic education and training;
>
> f) giving employees voice through ombudsmen systems that treat concerns professionally, fairly and promptly and prohibit retaliation;
>
> g) recognizing that the top staff leaders – the chief financial officer, General Counsel and human resources leader – must be both partners to the business leadership and, ultimately, guardians of the corporation; and
>
> h) designing compensation systems so that top business leadership are paid not just for performance, but for performance with integrity. "

The global dimension of the crisis calls for the adoption of a real inclusive and cooperative approach across countries and stakeholders in order to curb corruption, raise standards of transparency and accountability, and restore the public trust. The private sector as well as the Government and civil society need to work cooperatively in order to offer greater economic opportunities for the wellbeing of the society. Particularly in Italy and in Europe in general, sound and consistent political governance is called for to provide guidance in this period of extraordinary change under economic difficulties. The current uncertaninties concerning the recent political and economic developments of the European Union (tension between the core member countries Vis-a-Vis the peripheral member countries on how to handle the sovereign

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[37] Ben W. Heineman, Jr.,"View from the inside – Robust anti-corruption programs in a high-performance with high integrity global company", in Transparency International's Global Corruption Report 2009, 81.

[38] Ben W. Heineman, Jr.,"View from the inside", 83.

debt crisis, the large scale immigration from North Africa, the resurgence of nationalisms) require a cooperative action of responsible member State governments and private businesses to restore the conscience of public interest.[39]

VII. **Conclusion: Can the Fight against Corruption be Improved?**

Enron and Parmalat were not isolated cases. Numerous reports and studies regarding both legal and business circles around the world have shown that fraudulent behaviours are well seated worldwide.

No doubt that there is a relevant decline in ethical standards, in the belief in integrity, honesty, patience, and trust in business. Accounting misstatement, non-existent asset reporting, lack of transparency and conflict of interest are pervasive in the financial world. Shareholders, workers, and general public dramatically have supported the catastrophic consequences of this systemic greed.

The excessive reliance on the private sector and the role of the market place without building an adequate capacity of monitoring and controlling has been a great failure for public policy and public administration in the US and other advanced economies. On the other side, the emerging economies, like China, India and Brazil, which are growing at a substantial rate, are facing their own problems, mostly related to inflationary drives. Anyhow, under globalization, all countries have a common interest in cooperating to ensure the stability of global finance.

While regulatory reforms, oversight and enforcement are important to combat the current uncertainty and mistrust, there is plenty of evidence that neither the imposition nor enforcement of new rules, nor the elaboration and diffusion of codes of conduct is sufficient to prevent reckless or fraudulent behaviours. The focus should be placed on restoring the culture of integrity and the common good, and making it transparent to the public. The individual self-interest should be oriented toward the well being of the company which is made of owners, investors, staff and management, all with different roles, responsibilities and interests. Aligning executive compensation with performance is important not only for preventing managers from unduly appropriating company resources, but also for setting the proper incentives for them to focus on sustainable profitability and adequate risk management. Without the commitment of the major players in global business, the fair rules of the game will never be effective.

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