Roads to Ruin
A study of major risk events: their origins, impact and implications

A report by Cass Business School Report for Airmic, sponsored by Crawford and Lockton

Presentation by Professor Alan Punter
The study

• 18 case studies of companies that experienced crises
  – Variety of industries, sizes and types of crises

• Each case study examined:
  – What happened
  – Why it happened
  – How management responded
  – Immediate and longer-term consequences
  – Role of insurance
  – Risk management lessons to be learnt, by specific companies involved, and companies in general
The case studies

Corporate misconduct – fraudulent accounting & other
1. AIG and AIG Financial Products (2005 & 2007)
2. Arthur Andersen (2001)
3. Enron (2001)
5. Northern Rock (2007) – UK bank failure

Explosion and fire
8. BP Texas City Refinery (2005)
The case studies, cont

IT-related
10. EADS Airbus A380 (2004 onwards) – launch delay
11. UK Passport Agency (1998/9) – new IT system

Product-related
15. Firestone (1978 and 2000 onwards) – tyre recalls
16. Land of Leather (2007 onwards) – product liability and recall

Transport
Summary case study - AIG

AIG and AIG Financial Products (AIGFP)

• Revelations following an allegedly sham financial reinsurance contract led to the forced resignation in 2005 of AIG’s long-term CEO Hank Greenberg and a weakening of its share price and, more importantly, its credit rating.

• Two years later large mark-to-market losses on Credit Default Swaps (CDSs) within AIG’s subsidiary AIG Financial Products led in 2007 to AIG incurring large book losses and losing its investment grade credit rating, necessitating a rescue operation by the US Government.
Summary case study - AIG

AIG share price
Summary case study - AIG

Risk management lessons

1. Senior management should pay attention to the upside risks, not just the downside risks, coupled with the risk of a lack of understanding of the business by top managers and the Board

2. Beware of the cult of the personality
   • Hank Greenberg
   • Joseph Cassano

3. Failure of the non-executive directors

4. Insurance risks are not the same as banking risks

5. Excessive use of offshore vehicles

6. Alignment of risk and remuneration – the curse of the trader’s option

7. Post-crisis reputation management
Summary case study - BP

Texas City Refinery explosion & fire, 23 March 2005

- 15 people killed, hundreds injured
- Plant acquired when BP merged with Amoco in 1998
- History of poor maintenance and accidents
- Report by consulting firm in January 2005 “We have never seen a site where the notion ‘I could die today’ was so real”
- Good immediate response by BP senior management
- Internal (Mogford Report, December 2005), independent (Baker Report, January 2007) and external (CSB Report, March 2007) investigations
- Hundreds of millions of dollars paid in compensation to victims, criminal penalties and health & safety fines
Summary case study - BP

BP share price
Summary case study - BP

Risk management lessons
1. Rapid growth resulting in organisational complexity
2. Management commitment – not walking the talk
3. Management needs to take accountability for safety
4. Take notice of early warnings signals ...
5. ... and learn from your own experience
6. Compliance should be more proactive ...
7. ... and follow through
8. Corporate governance – Board expertise and experience
9. Lessons at operational level (Mogford findings) – the Texas City incident “was a preventable incident. It should be seen as a process failure, a cultural failure and a management failure.”
## Some key consequences

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<th>Case study</th>
<th>Impact</th>
<th>Collapse of company</th>
<th>Government rescue</th>
<th>Chairman &amp;/or CEO lost job</th>
<th>Company &amp;/or senior execs fined</th>
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Some key consequences, cont.

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Summary of lessons

1. Board skills and NED control (or dysfunctional Boards)
   - The Board and Non-Executive Directors (NEDs) not being in effective control of the business
     - For instance, the Board of Northern Rock did not seem to understand the fatal flaw in their business model of over-reliance on the wholesale money market.
     - Dominant CEOs running rough-shod over the Board, such as in the cases of AIG, Enron and Independent Insurance.
   - Leaders or NEDs as a whole lacking the skills necessary to exercise oversight of the business
     - For instance, the NEDs of Enron and Independent Insurance do not appear to have challenged how the business was achieving exceptional results, before the frauds became apparent for other reasons.
Summary of lessons

2. Board risk blindness

   – The Board not focussing on important risks, including threats to the company’s reputation and ‘licence to operate’
     • For instance, Railtrack jeopardised its safety reputation and ultimately lost its ‘licence to operate’ because it subcontracted its key track and maintenance operations.

   – The Board not setting and controlling risk appetite
     • For instance, EADS Airbus using new and unstandardised technology to design and construct the A380. Whereas, in contrast, Coca-Cola made the decision within 24 hours to withdraw the troubled UK launch of Dasani, rather than risk further damage to the Coca-Cola reputation.
     • Or inappropriate incentives, whether explicit or implicit, such as the cases of Arthur Andersen (more interested in generating consultancy fees than being strict on Enron’s audit), BP (just 15% of bonus linked to safety, 70% to financial performance), Shell (executive bonuses linked to oil reserve estimates).
Summary of lessons

2. Board risk blindness, cont.

– Failure to appreciate the risks presented by complexity, both as a cause of cause and exacerbation of events

• For instance, the EADS Airbus A380 project involved complexity of product design, IT systems, manufacture and assembly, exacerbated by the political demands to share work ‘fairly’ between the operations in France, Germany, Spain and UK, and to share power in a Franco-German management structure (for example with two CEOs, one from each country).

• The Texas City refinery explosion was partly the result of BP’s merger with Amoco and the failure to rationalise the management structure and integrate the safety cultures. In major M&As, doing the deal is the exciting part; completing the integration of management structure and operations is much less exciting and a long slog.
Summary of lessons

3. Failure of Board leadership and implementation on ethos and culture

– The Board did not set and universally apply an adequate and coherent business and moral compass

  • Many examples, such as Arthur Andersen not challenging Enron’s accounting methods because it wanted to get more consultancy fees, and then cynically applying its document shredding policy as soon as trouble loomed.

  • Shell preaching ethical leadership whilst exaggerating oil reserves to boost leader’s bonuses. Such a perception of ‘double standards’ was present in the Maclaren US and UK pushchair recalls, and SocGen’s apparent earlier tolerance of Jérôme Kerviel’s rogue trading.

– The Board failed to create and embed throughout their organisation a coherent strategy on safety matters

  • For instance, an inadequate safety culture was the underlying cause of the crises at Buncefield, Railtrack and BP Texas City refinery.
Summary of lessons

4. Defective flow of important risk information

— Both across the organisation and from bottom to top
  • For instance, BP was criticised following the Texas City refinery fire & explosion for failing to absorb the lessons from previous incidents at its Grangemouth refinery.
  • At EADS Airbus design and construction problems on the A380 were suppressed for 6 months before being passed up to senior executives.

— More generally there appears to be a risk ‘glass ceiling’, with often an inability or unwillingness of risk management and internal audit to report on risks to the C-suite and NEDs, particularly risks arising from strategy, behaviour and culture (as opposed to operations)
  • Senior staff at Independent Insurance appear to have quietly left the company rather than report their concerns to NEDs, auditors or regulators.
  • Warning signs detected by internal compliance at SocGen do not seem to have been taken note of at Board level.
Questions & Answers

Thank you