The Gordon Gekko Effect: Culture and Risk Management

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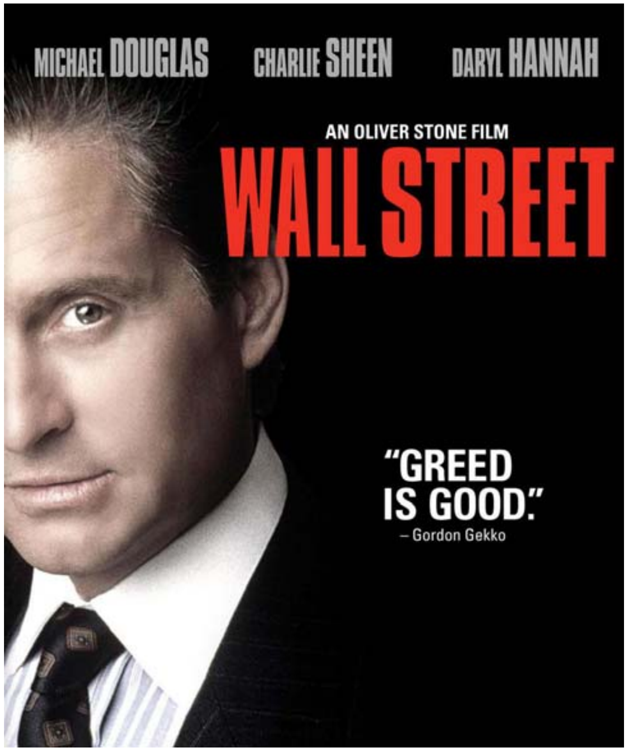
Motivation

"The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA."

– Gordon Gekko



Motivation

- What is culture?
- Does it matter?
- Can you change it?
- Some examples

What Is Culture?

- "Culture consists of patterns, explicit and implicit, of and for behavior acquired and transmitted by symbols, constituting the distinctive achievements of human groups, including their embodiments in artifacts" – Kroeber and Kluckhohn (1952)
- "Shared values… and norms" – O'Reilly and Chatman (1996); "shared basic assumptions… learned by a group… taught to new members as the correct way" – Schein (2004)
- Common denominator: **shared** values and behavior
- Qualitative, not quantitative; big data is changing this

Does It Matter?

Yes:

- Smith (1759, 1776), Mill (1843), Marx (1859), Weber (1905): political economy
- Hamilton (1964), Trivers (1971), Wilson (1975): kin selection, altruism, reciprocity, sociobiology
- Richerson and Boyd (2005): culture and human evolution
- Guiso, Sapienza and Zingales (JEP 2006, JF 2013): strategic mortgage defaults, trust and growth
- Young (2014): social norms; Gordon and DiTomaso (1992), Sørensen (2002): consistency and performance

Can You Change It?

Culture Explained More By Biology Than Physics

- Culture is a **social** phenomenon
- Values are transmitted from person to person
- Analogous to epidemiology
  - Gordon Gekko = Patient Zero of "Greed is good"?
- Psychology drives it (risk perception, group dynamics)
- Three factors contribute to its transmission:

1. Top down: source of corporate values (leadership, authority)
2. Bottom up: composition of corporate population
3. Environment: some values will transmit more easily in different environments than others (risk, regulation)

Top Down: Authority and Culture

Financial Incentives Unnecessary To Defer To Authority

- Max Weber: different types of authority (charismatic, traditional, legal-rational)
- Nuremburg trials of Nazi war crimes: “following orders”
- Milgram experiment (1961): “Obedience to Authority”
  - Volunteers will administer dangerous electric shocks
- Zimbardo experiment (1971): “Lucifer Effect”
  - Volunteers will physically and mentally abuse others
- Authority often supersedes volunteer moral judgment
  - Minimal financial incentive needed

Bottom Up: Composition and Culture

Selection Bias Can Influence/Create Culture

- Corporations select specific types of employees
- Ho (2009): 1990s Wall Street sought Ivy League "best and brightest"
  - Rationalized Wall Street negatives to fit elite self-image
- Lyng (1990): Shared "edgework" creates shared values
  - Risky work creates group sense of elitehood; gallows humor
- Quants bring their own culture (physics, math, CS, etc.)
- Demographic shifts can change corporate culture
  - Population dynamics: replacement, promotion, expansion

Environment and Culture

Many Aspects of the Environment

- Competition, hierarchy, business conditions, regulatory climate, etc.
- Douglas and Wildavsky (1982): risk priorities reflect cultural values; prioritizing risk is how the culture "sees" its environment (insurance vs. finance)
- An important environmental condition is the importance of the culture
  - Corporate culture rejects, ignores opposing values; even constant criticism can be tamed by culture (Weeks 2004)
- Corporate culture applies to regulators too!

Illustrative Examples

Case 1: Long-Term Capital Management

- LTCM's culture consistent with experimental financial engineering firm; collapse a "normal accident"
- However, LTCM's creditors saw LTCM as nearly riskfree
  - Virtually no "haircut" on loans to LTCM; ""We had no idea they would have trouble—these people were known for risk management. They had taught it; they *designed* it" (D. Napoli, Merrill Lynch)
  - LTCM exemplified shared Wall Street elite values of intelligence, ambition, success
- Shared failure among the LTCM **creditor** culture?

Illustrative Examples

Case 2: AIG Financial Products

- CEO Greenberg uses personal risk management style to build AIG into insurance powerhouse
- 2004: AIGFP sells first CDS on CDOs under Cassano
- 2005: Greenberg ousted, AIG risk culture on autopilot
- 2006: AIGFP stops sales of CDS
- Cassano defends CDS risk analysis until his ouster in February 2008
- Overconfidence in AIG's risk management culture led to several balance sheet time bombs

Illustrative Examples

Case 3: Lehman Brothers and Repo 105

- Repo 105: accounting trick adopted by Lehman Bros.
- Kept secret from board, SEC, outside disclosure counsel
- "Shopped" British law firm, outside auditors
- Global financial controller warned of reputational risk, *two* chief financial officers ignored warnings
- Story pieced together in bankruptcy court
- Corporate culture saw risk of disclosure as more important than other financial risks

Illustrative Examples

Case 4: Rogue Traders and Société Générale

- Jérôme Kerviel built up a €49 billion long position; SocGen's total capital was €26 billion at the time
- Kerviel's activities were missed by four levels of management for over a year
- A culture of neglect in investment bank division
  - For historical reasons, SocGen elites preferred retail division
  - Investment bank a mere "cash machine"
- Kerviel caught by single monitor in SocGen Basel compliance

Illustrative Examples

Case 5: The SEC and Bernie Madoff

- Six "red flag" complaints from 1992-2008 (OIG 2009)
- Two examinations unaware of each others' existence!
- Earlier negative results biased the SEC against credible subsequent complaints
- SEC: hierarchical, low morale, risk-averse (GAO 2013)
  - "managers have been afraid to close cases or make decisions because senior officers want to minimize the chances that they would be criticized later." – anonymous SEC respondent
  - Criticism strikes against legitimacy, "legal-rational" authority

How To Combat the Gekko Effect?

- Zimbardo (2007): “Resist situational influences”; easier said than done!

A Modest Proposal:

- Recognize that culture exists and it matters
- Explicitly define the ideal culture for your organization
- Institutionalize mechanisms for shaping culture:
  - Invite and facilitate constructive debate (“red team”)
  - Engineer diversity while preserving cultural identity
  - Instill clear values: honesty, responsibility, admitting mistakes, refusing unjust authority, etc.
  - Create metrics, feedback loops, and reinforcement learning, i.e., NTSB

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