

Compliance and ethics, a case study of Banco Marka

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“Some men worship rank, some worship heroes, some worship power, some worship God, and over these ideals they dispute & cannot unite--but they all worship money.”

- Mark Twain's Notebook

The purpose of this paper is to use the Banco Marka story of bypassing banking regulations by using inside information regarding foreign exchange rates as a compliance case study. The main argument of this paper is on behalf of higher standards of compliance for foreign exchange trading (FX) and banking regulations in Brazil.

In the conclusion I'll explain why Emerging Markets, such as Brazil, should consider implementing foreign exchange (FX) regulation following the Singaporean example and the Canadian regulatory framework. Perhaps Canada might be famous for pristine snow in its rural north region, but after 14 months into our current liquidity crisis Canada's finances are still very sound (see FT article)¹.

1) Compliance and ethics, the case study of Banco Marka;

On January 13, 1999 during the government of President Fernando Henrique Cardoso, the Brazilian federal government announced the definitive end of the pegged

¹ 'Boring' Canada's financial tips for the world, By James Flaherty Published: November 12 2008 19:51 | Last updated: November 12 2008

exchange rate policy to the dollar. These decisions had permanent political and social impacts on the economy.

Banco Marka had twenty times its equity committed to contracts of sale in the futures market for U.S. dollars. Its owner found the Bank insolvent under the currency devaluation of 1999. Like other financial institutions, such as Banco FonteCindam, owned by the former director of the Central Bank, Luiz Antonio Goncalves; Banco Marka senior management bet on the stability of a strong Real (name of the local currency), while the other financial institutions in the country, such as Banco Itaú and Banco Bradesco, prepared for the stronger dollar.

With the devaluation, the owner of Banco Marka, Mr. Salvatore Cacciola, was unable to fulfill the Bank's commitments and asked the Brazilian Central Bank (BCB) for help. As a result, Mr. Cacciola decided to try to use the influence of one of his investment consultants, Mr. Luiz Augusto Braganza, who was a childhood friend of the then Central Bank President, Francisco Lopes. Mr. Braganza asked Mr. Lopes to interfere on the matter to avoid, what he described as, the possibility for a major banking failure. By doing so the senior managers of Banco Marka made their first mistake by ignoring most of the recommendation of the Basel Committee on Banking Supervision².

2) Leadership and Culture

"Risk is a part of God's game, alike for men and nations."

- Warren Buffett

As pointed out by Professor Laura Nash in her 1990 book *Good Intentions Aside: A Manager's Guide to Resolving Ethical Problems*, "*today the topic of business ethics is*

² Committee was created in 1974, in Basel. See box 3.2 page 71 Compliance Management Book.

acknowledged to pervade every area of the corporation just as it is a recurred issue in the media". Coincidentally, I had the honor to meet Prof. Nash in 1998, during her lecture at the Business School of the Catholic University of Rio de Janeiro (PUC-RIO). She was visiting Brazil to promote her book about business ethics; however, due to all the corruption scandals that were taking over the country's media in the late 90's the topic of conversation moved towards corporate governance. In the case of Brazil, as noted by many attendees, corporate 'white collar' crimes seldom end with prosecution. From a legal standpoint, executives accused of corporate crimes and industrial espionage were able to wait for their sentences from home, which was the case for Cacciola in 1998. As a result, the downside of executive misconduct has been very low.

The role of senior management from the Brazilian Central Bank (BCB), in the case of Banco Marka, is quite fascinating. In his own defense the President of the Brazilian Central Bank claimed that he was under a lot of pressure from smaller bankers and the board of the central bank collectively agreed to "tip off" the smaller firms, such as Marka, with inside information. With the floating dollar Marka would lose large sums of capital, therefore, the Presidents position was the Central Bank could save the financial system and avoid further collapses by "tipping off" Bankers. According to Mr. Lopes the only feasible solution was for the Central Bank to pass information to these firms³.

For the board of the Brazilian Central Bank, its intervention operations on behalf of banks Marka and FonteCidam were justified as a legitimate exercise of its discretionary power; especially because such action could eliminate the risk of an attack on the country's foreign reserves, at a time of great uncertainty, which could have brought

³ New York Times article, Brazil Rebuts Currency Insider Charges, April 16, 1999.

on an even higher costs to the federal government⁴. Therefore, their line of reasoning regarding these operations was to reduce the risk of additional pressure on the high price of dollar, which would mean even greater cost to the government in the case of currency fluctuations. This situation could be easily correlated to what happened, in the United States, at Adelphia, MCI or Tyco.

But for everyone's surprise there was a twist and two months later, five witnesses leaked the case alleging that Mr. Cacciola bought inside information from the BCB itself. Without any explanation Mr. Lopes resigned in February of 1999. The interim head of the Department of Surveillance of the BCB was Tereza Grossi, which mediated the negotiations and called on a letter from the Bolsa de Mercadorias & Futuros (BM&F, the Brazilian Stock Exchange for Commodities and Foreign Currencies) to justify the victory. However the complexity of these decisions were fairly questioned and resulted in the opening of a Commission of Parliamentary Inquiry (CPI).

According to one of the reports from revista Veja, the exchange of correspondence between the Central Bank and the BM&F senior management, for example, was signed by the then superintendent Dorival Rodrigues Alves, who died during the case in 1999, and appears dated January 14, but only arrived in Brasilia on January 15. On the morning of that day, one of the overseers of the stock exchange, Antonio Carlos Barbosa Mendes, took a corporate jet in São Paulo and flew to Brasília to deliver the letter in hand. Therefore the correspondence was received by the Deputy Head of Central Bank supervision Mr. Ricardo Liao.

⁴ This procedure completely ignored the Golden Rule as expressed by Anthony Knerr.

From a compliance perspective the main questions are; was this controversial rescue necessary? Why did the central bank set up this farce? Why did BM&F management feel obliged to issue a letter to justify an operation that, in theory, they were already studying? According to Mr. Edemir Pinto, the superintendent-general of the BM&F stock exchange, "At no time during the process, BM&F was concerned about the situation of either Banco Marka or any other A, B or C Bank". The direction of the BM&F clarified that two weeks prior to the scandal going public, Banco Marka had guarantees of \$78 million (of Reais R\$) for its operations on waver of U.S. dollars. On Jan. 14, when the BC gave aid to Salvatore Cacciola's Banco Marka, they already had a leak, because of mistakes in FX bets. But the guarantees were sufficient to cover the positions of Marka up until a rate of \$1.33 Reais - and that day the dollar was at \$1.32 Reais. Therefore, Banco Marka had to bear their losses. Furthermore, the BM&F has an emergency fund, of R\$120 million Reais, for this type of situation. In addition to the guarantees of Marka, the emergency fund would reset to the positions of Marka up the price of the dollar to reach \$1.48 Real.

After the scandal the government decided to change the structure of oversight on the Central Bank Foreign Exchange system. In order to try decreasing the influence of politics within the Central Bank (BCB), the federal government created a new oversight commission with the main goal of starting to move the CB towards a more independent institutional role, following the US-Federal Reserve Bank model. The CB also moved towards a more transparent business model to settle its FX trades and FX policies. The CPI investigation decided to implement the suggestions from one of the advisors and technicians involved in the investigations. Mr. Everardo Maciel, the Federal Revenue

Secretary presented the judiciary commission with some proposals to prevent large corporations from no longer paying withholding taxes.

4) Procedures

During his testimony to the CPI, while talking to the politicians, Mr. Cacciola was answering the questions in a manner that exposed the lack of knowledge of some politicians with regards to financial markets operations. Therefore, for a while, there was an observation within government and the opposition that there was obvious evidence that the government was left under a very bad situation. The CPI, concluded that there was loss of about \$ 1.5 billion for public coffers⁵.

The CPI accused the high ranks of the CB of trafficking in influence, reckless management and various other crimes. During testimony in committee, Mr. Lopes refused to sign a term compromise to speak only the truth and was ordered to prison⁶. In 2000, prosecutors asked for custody of Mr. Cacciola with fears that the ex-banker was already planning to leave the country. He was sentenced to 37 days in jail, but escaped in the same year, after receiving a habeas corpus from the Supreme Court Minister Marco Aurelio Mello – which was shortly repealed. But it was too late, once the authorities discovered the whereabouts of the former banker, the Italian government denied the request by the Brazilian government to return Mr. Cacciola to Brazil for prosecution. The Italian government's counter argument has been regarding his Italian citizenship, alleging that the Brazilian Government could not expatriate him for trial.

⁵ According to some news articles (please refer to annex) the loss was US\$1.35 billions, due to poor transparency over government led investigations during that period, my total findings differ on average by US\$ 200,000.

⁶ He was later released due to an old law (Lei 11.036/04) which set the privilege of special forum for presidents and former presidents of the Central Bank.

During the investigative process, another important step taken by the federal police was to tap the phones of several CB employees. In order to understand who was leaking the information not only to these two banks, but also to other institutions that seemed to be predicting the currency fluctuations being shielded from their previous risky positions.

The local banking culture played a major role, if we look at the background of Mr. Cacciola's he started as a trader in the 60's, working for a firm that was very famous for recruiting the most ambitious and ruthless traders of its time. The modern history of the Brazilian financial services industry is completely intertwined with the personal history of traders that started working in a poorly regulated environment in the 60's and quickly adapted to the culture of speculation that dominated in the 70's, 80's. Until the Banco Marka scandal the dominant psychology was "*buy the rumor, sell the fact*"⁷, but in Brazil the '*fact*' has been available in advance (for some institutions willing to be unethical) or conveniently fabricated at a fee (bribe). Most of the traders (from his generation) developed their careers in banking. And many became billionaires betting and hedging their fortunes against the foreign exchange rates applied during the dictatorship regime.

During the dictatorship period there was a prevailing mentality of "no one will touch me, because I have connections". The country's financial system was being run by a brotherhood system where practices such as traffic of influence and insider trading were largely acceptable. The existing White Collar Law (Lei do Colarinho Branco) LEI No

⁷ It is the tendency for the price of a currency to reflect the impact of a particular action before it occurs and, when the anticipated event comes to pass, react in exactly the opposite direction. This may also be referred to as a market being "oversold" or "overbought"

7.492, was created in June of 1986⁸, but after the law was ratified traders had near zero government oversight, regarding insider trading.

5) Regulations

Although the CB used to be a semi-autonomous agency with its own separate legal identity, it was in fact hierarchically attached to the Ministry of Finance, and its President reports to the Minister and not to the President of the Republic or Congress. This lack of independence is connected to budgetary aspects as well, being the BCB budget subject to the Ministry's appraisal and approval. There are severe budgetary constraints, at the moment, affecting training, equipment, travel and salary scales – which affect Government as a whole.

In 1994, by the issuance of Resolution 2.099, the (The Basle Committee for Banking Supervision) Accord was internalized and few regulations were really put in place until the 25 Core Principles were released. In 1998⁹ many regulatory changes began to take place. The establishment of a World Bank program with the BCB to enhance supervision practices gave the issue of compliance a new thrust. The conditionality imbedded in the IMF assistance program further pressed the case for a positive increase in compliance.

Soon after the regulatory changes began to take effect Brazil endorsement of compliance measures, which was subdued by the more pressing economic issues at the time, but Brazil's Central Bank, as supervisory and regulatory authority, included full compliance to the 25 Core Principles as a major strategic planning goal for 2001. The

⁸ Dictatorship officially ended in 1985, <http://www.planalto.gov.br/CCIVIL/LEIS/L7492.htm>

⁹ The first assessment of compliance made by the Central Bank was the reply to the questionnaire of the BCBS (The Basle Committee for Banking Supervision) was in 1998.

stabilization program arranged with the IMF represented a further incentive for compliance efforts, as some of the programmatic conditions involved are directly related to the Principles.

On preconditions for effective banking supervision, the country can be considered nearly fully implemented: the only setback is some lack of independence of the supervisory authority. On principles guiding methods of supervision and inspection guidance, much progress has been made. Sound accounting and reporting systems exist; consolidated on and off-site supervision exists; and cross-border supervisory agreements exist, but need some fine-tuning and individuals need to be trained more.

According to the paper, *Ending Up in Pizza: Accountability as a Problem of Institutional Arrangement in Brazil*, by Matthew M. Taylor and Vinícius C. Buranelli. Judicial delays and congestion complicate the task of carrying the legal sanctioning process to its natural end efficiently. Weak electoral accountability in Brazilian politics, especially the weak ties between voters and legislators, are often complicated by the loose and undisciplined party system, which yields perverse incentives for the creation of political alliances. The author highlights how “*These relationships create a self-reinforcing cycle of policymaking for the sake of coalition building for the sake of policymaking*” affecting the Brazil economy and discouraging its citizens to respect the rule of law.

6) Conclusion

“It is necessary for mechanisms to exist that are more efficient in the investigation [of corruption] and [for] the people involved [to be] condemned.”

—President Luiz Inácio Lula da Silva, 2003

The story ends in a higher note because the case was successfully reopened under the current [Lula] administration. In 2005, former owner of the bank Marka was sentenced to 13 years in prison. Federal Prosecutor says he was "number one" sought by the Justice of Brazil. From a legal perspective the judiciary in Brazil has an excellent legal framework to punish executive crimes, however these prosecutions clouded by the possibility of political motivation.

Political scientists might argue that the motivations are purely political and that there are large partisan implications to the outcomes of this investigation; however I would like to counter argue that regardless of the outcome, or political motivation behind the case, the fact is that Mr. Cacciola is now in jail. This is an extraordinary example of improvement in the rule of law. If we associate this event with his repatriation process from Monaco back to Brazil, these two facts are a great example of institutional change.

7) Annex

Accountability as a Problem of Institutional Arrangement in Brazil, according to Gobar Integrity.org this is how the story developed: *“April of 1999 – Former Central Bank president Francisco Lopes is arrested after refusing to testify during a Senate inquiry into a scandal involving Central Bank officials who allegedly gave private banks advance warning of changes to exchange rates and interest-rate policy. During his three weeks as president in early 1999, Lopes had been responsible for massive US\$1.35 billion bank-sponsored bailouts of Banco FonteCindam and Banco Marka, and was replaced without explanation by President Cardoso. Shortly thereafter, Brazilian currency is devalued 39 percent. According to documents found by investigators in April, Lopes had hid US\$1.6 million in a foreign bank account. It was further revealed that four banks each allegedly paid US\$125,000 per month to Lopes to get inside information about monetary policy, including the future devaluation of the real. The bribery allegedly began two years earlier, when Lopes was the Central Bank's director of monetary policy. It was reported that Lopes had been blackmailed into performing the bailout by the head of Banco Marka, and that top government officials, including President Cardoso, were aware of Lopes' scheme and tried to cover it up so that they would not be tainted”*

June 1986 - The existing White Collar Law (Colarinho Branco) LEI No 7.492, created on <http://www.planalto.gov.br/CCIVIL/LEIS/L7492.htm>

November 1995 - The PROER: Program of Incentives to the Restructuring and Strengthening of the National Financial System, was created to avoid a repetition of the Mexican banking crisis. <http://www.bcb.gov.br/PROEREN>

April 2001 – A PricewaterhouseCoopers country study on business transparency shows that out of 33 countries, Brazil lost the most foreign direct investment because of corruption, government secrecy, and regulatory problems.

July 2002 – Brazil ratifies the Inter-American Convention Against Corruption, originally signed by President Fernando Henrique Cardoso, in 1997.

December 2003 – Lula signs a decree creating a Commission for Public Transparency and Combating Corruption, an 18-member advisory council operating out of the Comptroller General's office

December 2004 – Congress approves a constitutional amendment designed to make the judicial system more streamlined and accountable

RMCCI - International Capital and Foreign Exchange Market Regulation
<http://www.bcb.gov.br/?RMCCINORMSNORM>

The Office of the Superintendent of Financial Institutions (OSFI) was created to contribute to public confidence in the Canadian financial system.

OSFI's role is to:

** Supervise institutions and pension plans to determine whether they are in sound financial condition and meeting minimum plan funding requirements respectively, and are complying with their governing law and supervisory requirements;*

** Promptly advise institutions and plans in the event there are material deficiencies and take or require management, boards or plan administrators to take necessary corrective measures expeditiously;*

** Advance and administer a regulatory framework that promotes the adoption of policies and procedures designed to control and manage risk;*

** Monitor and evaluate system-wide or sector issues that may impact institutions negatively.*

OSFI's legislation has due regard to the need to allow institutions to compete effectively and take reasonable risks. The legislation also recognizes that management, boards of directors and plan administrators are ultimately responsible and that financial institutions and pension plans can fail.

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