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AUTHORS

Bora Aktan  <https://orcid.org/0000-0002-1334-3542>
Omar Masood
Senem Yilmaz

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Bora Aktan (Turkey), Omar Masood (UK), Senem Yilmaz (Turkey)

Financial shenanigans and the failure of ethics in banking: a review and synthesis of an unprecedented fraud

Abstract

Ethics and ethical decision-making are not new concepts or ideas in banking and finance. Frankly speaking, in today's business world, the prominence of ethical decision-making and corporate governance has expanded beyond the realm of academic world. This is evident via the extensive media coverage of corporate ethics crises such as well-known BCCI, Allfirst, Adelphia, Enron, Arthur Andersen, WorldCom and more recently Societe General among others resulting domestic and international regulations. Business ethics is considered critical for the reputation and competitive power of banks but banks are sometimes culpable of unethical behavior that costs to taxpayers billions such as the Imar Bank Inc. case in Turkey. This unethical behavior often takes the form of false financial statements to the creditors and misleading reports to the supervisory authorities. The main aim of this paper is to examine some of the causes of failure of the bank, the second, to scrutinize this unprecedented fraud, and the last, to deduct implications of the looting of Imar Bank Inc. within the framework of corporate governance and business ethics for a more robust supervisory system.

Keywords: banking, fraud, looting, ethics, corporate governance, regulation.

JEL Classification: G21, G34, M41, M42, M48.

Introduction

Banks as the oldest of all financial-service professions create and play a number of important roles in the economy such as the intermediation role by transforming savings received primarily from households into loans for individuals, businesses, and government in order to make investment; the payments role by carrying out payments for goods and services on behalf of customers; the guarantor role by standing behind their customers to pay off their debts when needed; the risk management role by assisting customers in preparing financially for the risk of loss to property and persons; the investment advisor role by aiding customers in fulfilling their long-range goals; the agency role by acting on behalf of customers to manage and protect their property or issue and redeem their securities, among others. These financial activities are important in ensuring that the financial system and the economy run smoothly and efficiently.

Examination of banks failures across the globe shows that the unethical behavior is one of the key reasons lying behind these undesired states. One of the unethical behaviors in banking is the connected lending, which can be described as lending to the group undertakings and related undertakings; associated companies; directors, controllers and their associates and non-group companies with which the bank's directors and controllers are associated. Other unethical behaviors in the sector are bribery, exploitation and misuse of authority as well as lack of transparency. In addition, political interferences, like using influence to finance risky public or private investments are some other ethical issues related to banking.

Business ethics is considered critical for the reputation and competitive power of banks but banks are sometimes culpable of unethical behavior whatever the reason might be that costs to taxpayers billions such as the Imar Bank Inc. case in Turkey.

The main aim of this paper is to examine some of the causes of failure of Imar Bank Inc in deep, the second, to scrutinize this unprecedented fraud, and the last, to deduct implications of the looting of the bank within the framework of corporate governance and business ethics for a more robust supervisory system. This paper is organized as follows: Section 1 provides a brief review of the previous studies. The case is reported in Section 2. Finally, the last section presents the conclusion and implications.

1. Previous studies

Banks, like large shareholders, are important elements of corporate governance as they are considered as significant monitors for other corporations' financial activities and for their financial expertise. They also have much interest to get their money back and have the power to demand it (Shleifer and Vishny, 1997). Aras and Crowther (2008a) clearly show that corporate governance is fundamental for any corporation to continue operations. This makes corporate governance much more important for banks since providing the clients with trust in sustainability is more vital for banks than for any other form of corporations. Moreover, Aras and Crowther (2008b) argue that disclosure regarding sustainability will increase as firms gain clearer understanding of the benefits. Thus, we expect firms and banks in particular also enhance disclosure on corporate governance practices, which leads to sustainability even more in the future. Based on the research of the banking institutions, a large number of customers prefer their money to be invested ethically. The

companies, which emphasize ethics in their operations, will be evaluated not only from the point of economic efficiency but also from the point of social efficiency (Carrasco, 2006). Moreover, Simpson and Kohers (2002) document a positive relationship between corporate social responsibility and financial performance in banking industry.

Since trust is one of the most crucial assets of banks one would expect less fraud in banking industry but this is not always the case. Mitchell et al. (1992) list seventeen behaviors that might be called unethical by the bankers most of which are internal behaviors. Cowton (2002) describes three aspects of ethics in banking that are integrity, responsibility and affinity. Especially the first two aspects are directly related to the topic of our study where the former is about the creation of trust, which is crucial for banking system, the latter is about the banks' need to take into account the consequences of their lending policies. Though Lamb (2000) also acknowledges that ethics is central issue in financial services he argues that financial institutions are vulnerable to ethical abuses and corruption more than any other industry is. In addition to this, he lists five factors which contribute to unethical behaviors in financial institutions: "the rapid convergence of all financial services industries into each others' territory, the brutal intensification of global competition, drastic reduction of profit margins, the commoditization of most financial services and huge number of mergers, acquisitions and consolidations resulting in elimination of many hundreds of banks, brokerage and insurance firms worldwide" (Lamb, 2000, p. 14). Green (1989) defines bankers' role as "one of stewardships based on trust" (Green, 1989, p. 631) but concedes that bankers are often exposed to moral failures and the contamination in banking is increasing due to deregulation and technological revolution. Knights and O'Leary (2005) identify unethical leadership that emphasized financial and individual performance as the cause of the corruption. Bozovic (2007) accentuates that ethical standards should be formalized in regulations; professional ethics-related advice contributes to moral reasoning; an adequate responsibility mechanism must be established and also bank managers must serve as role models for ethical behavior and professionalism. Hortacsu and Ozkan (2008) argue that the lack of adequate legal and regulatory systems in emerging countries exacerbates the violation of ethics. One interesting result of their survey study is that the bank managers do not consider partial treatment to those whom they have care relationship as unethical, which has caused numerous financial system failures in Turkey.

There is a growing literature on ethics and corporate governance in banking where individual ethical

violations of banks are investigated. Taylor (2007) investigates the scandal of the Royal British bank of 1856, Drennan (2002) studies the financial collapse of Barings Bank, Argandona (1999) examines the Ibercorp case, Uche (2004) discusses unethical practices of Nigerian banks and Knights and O'Leary (2005) explore the unethical behavior and corruption in National Irish Bank (NIB) and Allied Irish Bank (AIB). Not only the bad practices are studied but also the good ones are examined, e.g., Harvey (1995) and Kitson (1996) investigate the Cooperative Bank of the UK, which adopted an ethical banking strategy as a tool for differentiating itself from its competitors.

One solution to prevent these financial shenanigans comes from Molyneaux et al. (2004) that ethics need to be integrated with other processes so that it provides sound solutions to moral dilemmas and more teaching and discussion are needed for the vitality of ethics. Zadek (1998) also draws the attention to the need of practical mechanisms for balancing ethics, accountability and performance especially transformations in organizations, technology and regulations underlying patterns of globalization.

2. An unprecedented fraud: Imar Bank

Ali Babacan, former Minister of State, announced with the press release of 18/12/2003:

Cancelling the license for executing banking operations and accepting deposit of Imar Bank Inc on the 3th of July 2003 has uncovered the huge corruption, fraud and tax evasion of the finance history.

Imar Bank of Turkey Inc. was found as a privately owned deposit bank in 1928. The initial problem in the bank was approval of the change of control of it in 1984 that was acquired by Uzan (family) Group. Although downfall of the bank did not embarrass those, following the sector closely, it is very interesting considering the way to downfall and the great financial loss caused by it (Catalca, Aktan and Soydan, 2008).

The bank was taken under close monitoring list of the Undersecretariat Treasury of Turkey, which had been the supervision authority before the Banking Regulation and Supervision Agency (BRSA) was founded in 1999, on June 20, 1994. Due to the fact that almost all credits were made Uzan Group use, it became far from banking functions as well as deteriorated income-expenditure balance, decreased profitability and liquidity shortage. Because risk continued to concentrate on Uzan Group even after BRSA started to act, the bank remained under close monitoring. BRSA asked the bank to present a plan intended to solve its problems. The plans presented

were not considered credible. BRSA gave to the bank detailed instructions for reducing risks on Uzan Group and strengthening its capital structure. Because the bank failed to act according to these instructions, BRSA assigned a member for board of directors having rejection vote on July 12, 2001 and increased the number of the members to two on December 26, 2001. In May 2002, during capital reconstruction program, the bank reduced credit risks caused by the group's companies and the shareholders contributed to the capital. Then, BRSA resolved to withdraw the member having rejection vote in the directors' board in August 2002. Because BRSA representative continued to be in management, the matter was considered as settled and the transfer procedure was renounced.

The bank took on the chin in 2003 after the privileges owned by the two affiliated regional energy companies, which provided significant cash flow for the group companies cancelled by Electricity Supervision Committee. Moreover, the bank ceased to provide information and documents, which it was legally obliged to sent, for BRSA on June 26, 2003. On the same date, all the members of the board of directors with the exception of one assigned by BRSA rejected cooperation with the Agency and resigned. After the event was heard, the depositors rushed to the bank for drawing back their money. The license of the Bank for accepting deposits was cancelled on July 3, 2003 and then, the government transferred its control to Saving Deposits Insurance Fund (SDIF). To avoid spreading panic over other banks, the security applied to saving deposits was made limitless. Thus, it was projected that only saving deposits would be paid rather than all obligations and accordingly, SDIF would claimed bankruptcy for the bank. It was seen after the transfer that most of the managers and employees working for data process department of the bank had resigned within a couple of days before July 3, as well as computer discs had been removed and backup systems had been taken away. Upon that Merkez Investment Trade Inc. which executed data processing system of the bank and was under the control of the Uzan family, rejected to cooperate with managers of BRSA and SDIF, documents were started to be collected and compiled from the depositors and these documents were reviewed in the period between August 4, and September 1, 2003. Then, it was understood that the deposits collected by the bank were approximately ten-fold of that declared to BRSA and the difference was lost. Furthermore, it was understood that almost all banking transactions were illegal and also conflicted with general ethical rules.

The most surprising aspect of the matter emerged during compromising efforts executed by BRSA to

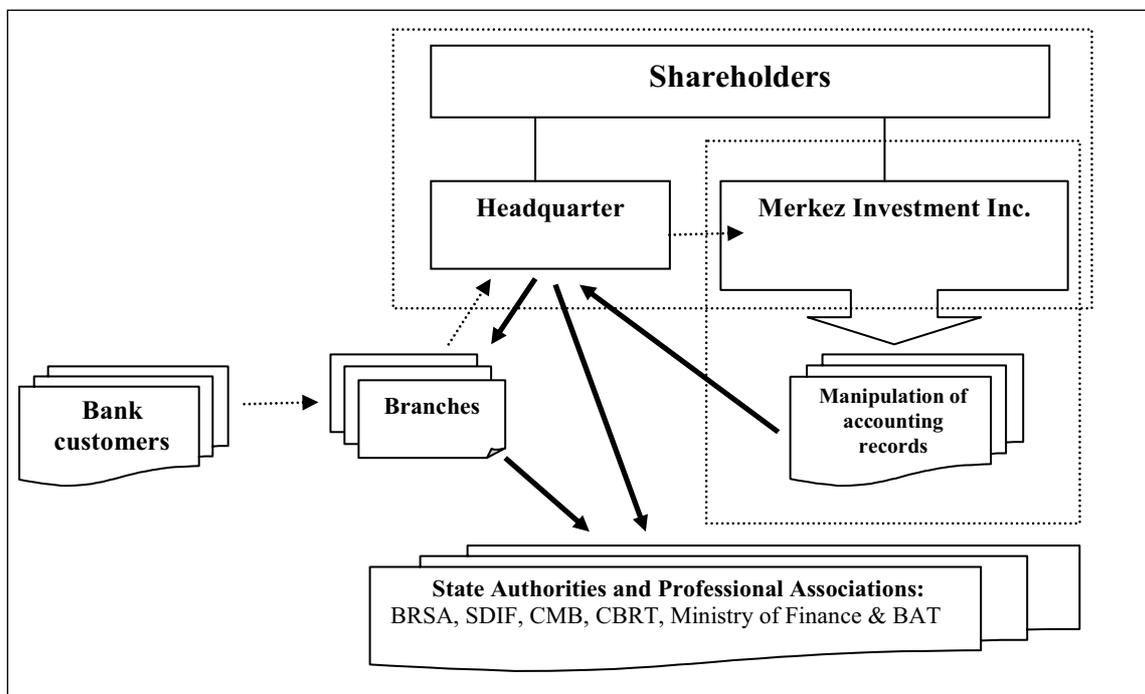
estimate the sums to be paid to the depositors. Total deposits amount was seen as TRY 750 trillion (approximately 0.5 million dollars) on the last reports sent by Imar Bank to BRSA in June 2003. It was found that this amount was 8.1 quadrillion (more than 5 billion dollars) after the documents collected from the depositors had been reviewed. Moreover, the bank converted some off-shore accounts into domestic accounts and sold treasury bonds without licensed for selling open to the general public. The bank kept two separate accounting systems. One of them reflected actual information and existed in the branches, and the second one was held in the general directorate for providing manipulated data for BRSA (Steinherr, Tukel and Ucer, 2004). According to this double-sided accounting system executed by Merkez Investment Trade SA, huge variations existed between actual data and manipulated data were provided for official authorities. Two programs were used in manipulating data. One of them was used to show deposits, taxes to be paid and expenditure accountings lower by giving fictitious debit-receivable records. The other one was used for deleting bond transactions from subsidiary records.

Many procedures conflicting with the regulations were detected. The data existing in the main memory of computer system of the Bank allowed for detections only relating to the year of 2003. These records helped to detect some points. The variation between the sum of actual deposits and that notified to the official authorities, the domestic deposits converted from Imar off-shore, short selling of government debt securities indices without permission, declaring deductions from deposits interests as lower (withholding, fund share, special procedure tax) and other illegal practices were detected. Considering the inspections in the branches, it was understood that branch directors' education levels were lower compared with those of other banks' branches. They were authorized at minimum level. For example, they were not authorized to open credit. They had to make prior demand even for repaying depositors their savings in small amounts. General reporting could not be obtained from the system existing in the branches. Account balances could not be obtained through the data processing system in the branches. The data to establish base for legal ledgers were produced by general directorate. The ledgers based on these data did not show actual balances.

Recording system was manipulated in a very interesting way in the procedures conflicting with the regulations. All transactions executed in the branches were transferred to the main memory in the general directorate (consequently Merkez Investment Inc). Financial tables of each branch and

the bank in general were produced by manipulating the data taken from the branches through software programs. Two programs were used in manipulating data. One of them was used for showing deposits, taxes to be paid and expenditure accountings lower by giving fictitious debit-receivable records. The

other one was used to delete bond transactions from subsidiary records. Legal ledger samples such as subsidiary ledgers, balance, book of final entry etc., which were produced by using manipulated data, were delivered to the branches.



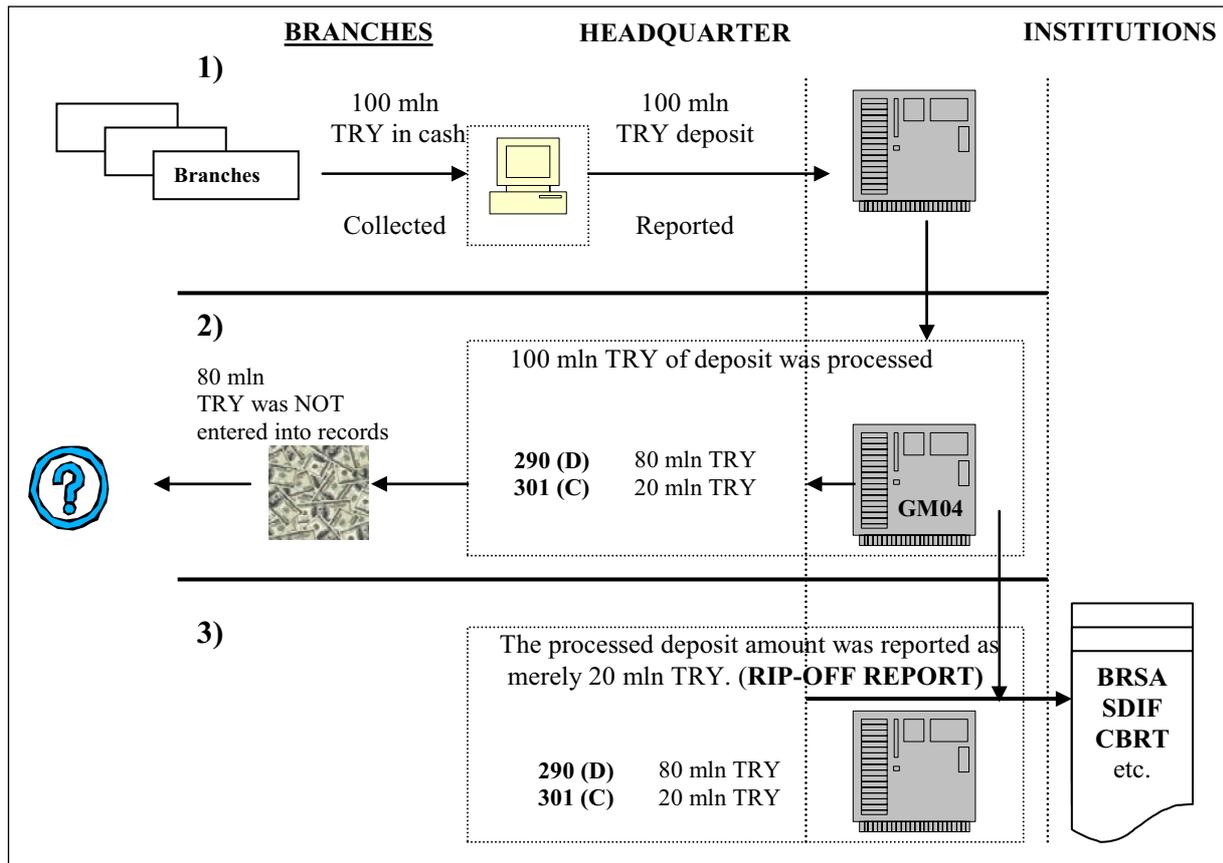
Source: BRSA (2003), Endeavours to Strengthen Turkish Banking Sector and The Imar Bank Case (in Turkish), Presentation, October.

Fig. 1. Manipulation of accounting records

The branches transferred all records displaying actual data to the main memory existing in the General Directorate. Deposits amount was reduced based on account through a program called GM04 that only a few people were authorized to use (310 time and saving deposits). Adverse records were issued for the required date, sum, account and branch. Some phrases such as “account closing” and “paid” were put on the subsidiary ledgers sent to the branches for the records produced by using GM04 and any remark was not provided. Branches’ current account under the number of 290 was used for adverse records. It could not be understood how the corresponding leg was established in accounting manner (only the adverse record done by the corresponding branch allows that account 290 numbered does not show balance in balance sheet of the bank from the point of view of banking technique) (see Figure 2).

Off-shore deposits were converted into domestic deposits. The bank made the companies of the group use credits from off-shore since 1994. Management of the bank was admonished about this point after

each inspection. Protocols were made with the bank for several times about reducing off-shore deposits. Finally, management of the bank was instructed not to convert off-shore deposits into domestic deposits and not to make off-shore deposits equal to it in 2003 (on 12, 25 and 26 June). The bank did not consider these notifications done since June 2003 and increased continuously its off-shore deposits for transferring them home. It was understood due to inspections that the sums equal to 616 trillion liras, 17.5 million dollar and 9.4 million Euros were converted into domestic deposits from off-shore after the instruction given on June 12. In addition, government debt securities (GDS) transactions conflicting with the regulations were done. Imar Bank ceased its brokerage activities completely in ISE (Istanbul Stock Exchange) on October 31, 1989, called its agent back and closed its office. Upon that, Capital Market Board (CMB) resolved to cease the bank’s brokerage activities and cancel its ISE membership certificate. However, the bank made illegal brokerage activities.



Source: BRSA (2003), Endeavours to Strengthen Turkish Banking Sector and The Imar Bank Case (in Turkish), Presentation, October.

Fig. 2. Under reporting of deposits: a sample

The bank systematically made short selling of GDS in significant amounts since October 2002. It was understood that the bank which GDS portfolio was 15 billion liras collected 728.4 trillion liras from the customers by showing as GDS selling since June 30, 2003. Transaction volume was hidden through software program used in deleting subsidiary records. All documents and slips relevant to the transactions were sent to the general directorate. Any slip or document was never kept in the branches. The authorities in the general directorate signed a few of the slips sent by the branches. These signed slips were reflected on 'entrusted securities' account. Thus, these sums entered into official records were registered by ISE. However, it was understood on July 3, 2003 that the GDSs registered by ISE, which were actually sold, also did not exist in the bank. The bank made GDS short selling to its customers equal to 728 trillion liras having nominal value of 1.023 trillion liras. Deductions made from deposits interest were declared lower than those actual. The taxes to be paid were shown lower by producing adverse records through GM04. Only 3-10% of income tax withholding deductions applied to the customers was paid. The bank did not make declaration and hid 125 trillion liras from the office in the accounts relating to the first 5 months of 2003 (Bolgun and Akcay, 2005). BRSA (2003) summarized these huge corruptions under five main categories:

- ◆ The variance between the actual accounts and manipulated accounts providing for official authorities (it was understood that, the actual accounts were equal to 8465 trillion TRY including currency accounts while the registered accounts declared to official authorities were equal to only 753 trillion TRY. It was understood that, the real deposits were equal to 7.8 quadrillion TRY after some manipulations were eliminated. The difference between actual and manipulated amounts equal to 7 quadrillion TRY was lost. The amount to be paid back to the depositors would be approximately 8 quadrillion TRY considering time and saving deposits).
- ◆ The amount converted from off-shore accounts into domestic accounts (approximately an obligation of 700 trillion TRY only between 12.06.2003 and 03.07.2003).
- ◆ Short selling of government debt securities indices without permission (selling government bonds, which actually never existed, vaporizing the collected 728 trillion TRY).
- ◆ Declaring deductions from deposits interests as lower (withholding, fund share, special procedure tax) (The bank did not make declaration and hid 125 trillion TRY from the office in the accounts relating to the first 5 months of 2003).

- ◆ Other illegal practices.

Summary and implications

Globalization of finance world, integration, advances in information technologies and especially financial innovations in the last couple of decades have deeply changed banking business not only in Turkey but also in other countries and forced the state authorities to deregulate national financial systems which open the doors to recurrent financial disasters.

Like others, the banking sector in Turkey has undergone very turbulent periods during the same period. Following the severe banking crisis years of 2000-2001 in Turkey, banks were successfully recapitalized and returned to profitability with sufficient financial resources to contribute to economic growth. Extensive reforms to the financial sector and the banking system were also introduced. Yet, these reforms did not prevent the failure of Imar Bank, which was mostly derived from accounting fraud.

This case clearly shows that false financial statements were produced by the principal shareholders of Imar Bank to the creditors of the banks and forged reports to the supervisory authorities over a long period. The processed deposit amount was not reported correctly then, the bank seemed to be relatively small in comparison to its collected real total deposits. It means that the accounting system of the bank was designed to guarantee that the system was run in accordance with the principal shareholders' requirements. This disaster also shows that internal control system of the bank lacked ethical values and didn't benefit to the interests of bank customers due to inappropriate corporate governance structure together with an ineffective external auditing. In addition, Fort and Hayward (2004) in their report on

the failure of Imar Bank, stress that even though the bank was under supervision due to connected lending; again no substantive testing of the system was done since the supervisors, both offsite and onsite, saw no reason why they shouldn't trust in the figures produced by the management.

This case is a very important example not only in terms of operational risk which supervisory institutions are not specifically equipped to detect; deposit insurance is also useful for overall financial stability as it imposes costs because of the stimulation of risk-taking, misallocation of scarce resources as well as reduced market discipline and moral hazard; competition is widely accepted as a positive phenomenon for most industries, but for banking it will continue to remain a controversial issue.

It may be considered as a special event for financial crime. Such events are general problem for developed western countries as well. However, the more important point is the fact that it also indicates failure of banking regulation and supervision functions in the country. Then, it emphasizes the importance of Basel Capital Agreement from the point of view of national/international banking activities. In fact, for these purposes, Basel Committee on Banking Supervision (1999, 2001, 2006) established some principles for effective banking supervision and to enhance corporate governance for bank organizations.

As a result, it was understood that collapse of Imar Bank is so huge that it can compete with other worldwide financial scandals and take place in the literature. This is a piercing example cost to taxpayers billions indicating that the best way of a bank robbery is to own the bank. Nowadays, many lawsuits against managers of the Bank and the principal shareholders are continuing.

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