

BUSINESS ETHICS AND OPERATIONAL RISK MANAGEMENT IN MALAYSIAN LOCAL CONVENTIONAL BANKS

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ABSTRACT. Purpose: This is a conceptual paper that discusses on the importance of business ethics and operational risk management in banks.

Design/methodology/approach: The paper review the literatures of business ethics and operational risk management in banks. The paper analyze the factors that lead to operational risk particularly internal frauds, operational risk management, issues related to business ethics, Machiavellianism, the relationship between business ethics and operational risk management in banks, Machiavellianism as the moderator and agency theory and Machiavellianism Intelligence theory as the underpinning theories.

Findings: A conceptual framework has been developed based on the literature review and the underpinning theories.

Research limitations/implications: The paper only concentrated in the banking industry in managing operational risk that is related to internal fraud. There are other variables that are not taken into consideration such as the quality of banks human resources and the internal control system. Future research can be done on the antecedent and outcome of operational risk management with business ethics as the antecedent of operational risk management and internal fraud as the outcome of operational risk management. Besides, future research on business ethics and operational risk management can be done in other industry such as education, manufacturing or logistic industries.

Practical implications: Banks could develop a robust operational risk management base on the dimensions of good business ethics. Machiavellianism variable as the moderator in the conceptual model will assists banks in identifying employees with high or low Machiavellianism personality traits.

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Originality/value: The proposed conceptual model helps banks to ensure the future risk of internal fraud occurrence can be eliminated. For future recruitment, banks might consider having personality test in identifying those applicants that might demonstrate high or low Machiavellianism when hired as bank employees.

Keywords: Operational Risk, Operational Risk Management, Business Ethics, Machiavellianism

JEL Codes: G30, G31

Recommended citation: Rahim, N.F.A., Hassan, H., *Business Ethics and Operational Risk Management in Malaysian Local Conventional Banks*, *Studia UBB Negotia* vol. 61, issue 4 (December), 2016, pp. 83-106.

1. INTRODUCTION

In the pursuit of profits and success in the business world, organizations especially banks will encounter risk in daily operations. Risk is about the ambiguity of a future result (Doerig, 2001). Vatsa (2004) defines risk as the likelihood of injury, damage, or loss and the probability that a particular unfavorable event occurs during a specified period of time, or results from a particular challenge. Even though risk is unavoidable but it can be managed. Risk management is an important practice that is needed to be implemented in banks. It helps in assuring the reliability of the operations and procedures being followed. According to Eccles et al. (2001), in the contemporary world of business, banks are exposed to a large number of risks such as:

(1) Market risk: Deals with the uncertainty of future earnings due to the changes in the value of financial instruments caused by movements in market parameters.

(2) Credit risk: Deals with the risk of loss that occur when an obligor fails to meet the terms of a financial contract or otherwise fails to perform as agreed.

(3) Operational risk: Deals with a wide-ranging of risk category pertaining to human error, management, or deficiencies in operating system.

4) Accounting risk: Related to the concerns on the using of estimates in preparing financial statements.

All these risks become the source of threat for a bank's sustainability and success (Shafiq & Nasr, 2010; Al-Tamimi & Al-Mazrooei, 2007).

Thus, one of the risks that are important and required for banks to manage is operational risk. According to Institut Bank- Bank Malaysia (IBBM) (2010), operational risk can be defined as (i) the risk that is resulted from the shortcomings in information systems and internal control system or from external events such as frauds that will lead to unanticipated losses. (ii) the risk that is related to either human errors, system failures and inefficient procedures which occur due to the breakdown in the internal control procedures either in the front, middle and or back office activities that can lead to unanticipated losses. Operational risk management is a framework that can detect the most critical operational risks to the organization in a timely manner and report effectively to all required individuals at the different levels of management with adequate information for taking necessary actions (Aung, 2008). As a result, operational risk can also be regarded as a weakness of the financial institution that can be reduced or eliminated through a proper management (Nicoletta & Cornelia, 2007).

The term operational risk surfaced in 1995 following the notorious scandalous collapse of Barings Bank, one of the U.K.'s oldest financial institutions due to the unethical behavior of Nick Leeson, a trader in the Barings Bank that committed internal fraud. Basel Committee (2003) defined internal fraud as dishonest or fraudulent acts committed by employee/s. Nick Leeson caused the bank to lose around U.S. \$1.3 billion and forced Barings into bankruptcy (Bhugaloo, 2011). In India, Satyam, a giant company that was listed among the top 13 Best-Managed companies in India, collapsed due to the management's internal fraud of the company and its stock holders financially. The management of the company displayed unethical behavior by fabricating accounts to showed large cash and fixed deposit balances in their balance sheets when in reality the company had no such balances. The financial fraud included overstating the company's cash balances by over 1 billion dollars, overstating number

of employees by more than 13,000 and withdrawal of the ghost employee salaries by the firm's top managers, inflating revenues by falsifying invoices and forging of the company's bank fixed deposit receipts (Goel and Ramanathan, 2014). In Malaysia, one of the notorious internal fraud case was done by an RHB Bank manager, Tan Khay Guan. He committed internal fraud at the Mergong branch in Kedah between April 5 and September 23 2004. Acting as the branch manager, Tan opened two current accounts without authorization and approved drafts valued at RM21 million to these accounts. RM19.3 million was transferred to a Rockwell and Bond Bank of East Asia account in Hong Kong with the intention to buy shares. He was arrested at the Bukit Kayu Hitam border checkpoint on October 31 2004 when trying to escape from the country (<http://malaysiaacrimewatch.lokety.com/bank-manager-fined-record-amount-for-criminal-breach-of-trust/>).

According to KPMG (2013), the most common factors that contributed to the unethical behavior were poor communications of organization's values or codes of ethics/code of conduct (81%), poor example shown by senior management (43%) and poor ethical culture within the organization (38%). Thus, the unethical business practice of internal fraud committed by Nick Leeson and others has raised the issue on the importance of good business ethics. It deals with the morality of an organization, from top management to the employees. Business ethics can be defined as a set of moral actions of an individual, as the element of a collective, that a person conforms while performing business activities without jeopardizing the business relationships within the business system and the broader environment (Bozovic, 2007). There are three types of business ethics issues which include systemic, corporate and individuals (Velasquez, 2012).

The main motive of the perpetrators committing internal frauds is mainly driven by the desire of living beyond their means and they are good manipulators. Thus, the perpetrators demonstrate the personality traits of Machiavellianism. According to Farah Ali et al., (2009), Machiavellian individuals are successful manipulators characterized by lack of interpersonal affect in interpersonal relationships, lack of concern with conventional morality, lack of gross psychopathology, and low ideological commitment. The perpetrators do not consider their acts as against business ethics or moral standards and perceived 'the end justifies

the means'. Thus, Machiavellian individual motivation can be considered as cold selfishness or pure instrumentality. Rather than having a unique set of goals, individuals high in Machiavellianism were assumed to have typical intrinsic motives (e.g., sex, achievement, and sociality). Whatever the motives, the Machiavellians pursue them in deceitful ways.

In a previous study, case study approach has been done to study operational risk management in one of a bank in Malaysia (Abu Hassan and Abdul Aziz, 2008) The study proved that continuous monitoring and appropriate inspection and rectification should be part of the package to manage operational risks effectively. In addition, employee involvement in the bank also plays a significant role in any enforcement of risk management practice. Case study approach was also used by Chalupka and Teply (2008) to study the operational risk management implementation in of a bank in Central Europe. Their study focused on the loss distribution approach and extreme value theory and found that the bank was facing strong exposure to operational risk events. Rosman (2009) in his conceptual paper stated that future research is needed in determining the risk management practices in banks.

In one of the business ethics study, Goel and Ramanathan (2014) explored the concepts of business ethics and corporate social responsibility (CSR) with a perspective that meaningfully CSR should be seen in the context of an overall paradigm of business ethics. They studied CSR through the framework of the stakeholder theory of the firm and postulate that the current CSR practiced by organizations is a division of business ethics with other dimensions of an overall ethics framework still not discovered. Berger and Herstein (2013) implied that religion and culture can influence ethical behavior in business particularly in India.

Previous study of Machiavellianism personality traits investigated the relationships between Machiavellianism, trait emotional intelligence and empathy, using an image task that required an appropriate empathic response to the emotional displays of others (happy, sad and neutral). Results indicated that Machiavellianism were positively associated with the experience of positive affect from sad stimuli (Farah Ali et al., 2009). O'Boyle et al. (2012) found that reductions in the quality of job performance were consistently associated with increases in Machiavellianism.

To the best of the author's knowledge, no previous studies have been done looking on the relationship between business ethics and operational risk management and the moderating effect of Machiavellianism

personality traits on the relationship between business ethics and operational risk management in Malaysian conventional banking industry. Base on the above discussions on the various knowledge and theoretical gaps to be filled in the paper, the author postulated business ethics as the independent variable while operational risk management is the dependent variable and Machiavellianism personality trait as the moderating variable.

The remainder of the paper will analyze on the factors that lead to operational risk particularly internal fraud, operational risk management, issues related to business ethics, Machiavellianism, the relationship between business ethics and operational risk management in banks, moderating role of Machiavellianism, agency theory and Machiavellian Intelligence theory as the underpinning theory. A conceptual framework will be proposed based on the existing literature review.

The conceptual model presented in this paper will help organizations especially banks in incorporating business ethics as the foundation for a good operational risk management. Furthermore, this model will assists banks in identifying employees that are prone to commit frauds.

2. LITERATURE REVIEW

This section will be discussing on the literature review of each variables and the underpinning theory.

2.1. Operational Risk In Banks

The Basel Committee (2003) defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events including legal risk but excluding strategic and reputational risk. On the other hand, the operational risk is a term that has a variety of meanings within the banking industry, thus for internal purposes banks may choose to adopt their own definitions (Doerig, 2001). This internal definition should take into consideration of specific situation of every bank, such as its size, and sophistication, its nature and complexity of its activities in an economic manner, considering the full range of material operational risks facing the bank and captures the most significant causes of severe operational losses (Doerig, 2001).

Other than the scandalous collapse of Barings Bank, the U.S. \$7 billion losses at Société Générale because of the unethical business practices of Jerome Kievel, demonstrates the flaw in managing operational risk (Medova & Berg-Yuen, 2008). Furthermore, the losses of \$US691.2m at the Allied Irish Banks (AIB) in 2002, and \$A360m losses at the National Australia Bank (NAB) in 2004, led to serious aftermaths for the institutions. In each of the cases, the losses are due to the actions of a single individual or groups of individuals acting in accordance with the incentives incorporated in their remuneration schemes (Ford, 2007).

Potential risks associated with the elements in operational risks are shown in Table 1.

Table 1. Potential Risk Associated With the Elements of Operational Risk

Elements	Potential Risks
Process	Breach of mandate Incorrect/untimely transaction capture, execution, and settlement. Loss of client assets. Mispricing. Incorrect asset allocation. Compliance issues. Corporate action errors. Stock lending errors. Accounting and taxation errors Inadequate record-keeping Subscription and redemption errors
People	Unauthorized trading Insider dealing Fraud Employee illness and injury Discrimination claims Compensation, benefit, and termination issues. Problems recruiting or retaining staff. Organized labour activity Other legal issues

Elements	Potential Risks
Systems	Hardware and/or software failure. Unavailability and questionable integrity of data. Unauthorized access to information and systems security. Telecommunications failure. Utility outage Computer hacking or viruses
External Events	Operational failure at suppliers outsource operations. Fire or natural disaster. Terrorism. Vandalism, theft, robbery.

Adapted from “Basel II: A Closer Look: Managing Operational Risk” by, KPMG, 2005, p. 7.

Moazinezhad et al., (2012) stated that risks in banking sector are different as compared to the other economic aspects, due to the following reasons; the number and variety of banking operations, different natures of banking operation, the capital position of banks and its limitation, protecting the interests of bank shareholders, status of depositors’ resources and their frequency, maintaining depositors’ interests and lastly variety in interests of banks and depositors. Banks are concentrating on operational risk because the exposure and effects can be fatal. Therefore, it has become one of the main risks of the financial sector (Karam & Planchet, 2012). According to Basel II (Basel Committee, 2003) there are 7 loss event types due to operational risk that can be faced by the banks. It is summarized in the following Table 2.

Table 2. Loss Event Types

Loss Types	Event
Internal fraud	Unauthorized activity such as fraud or theft. It involves a criminal act aimed at benefiting the perpetrator and aimed at causing a loss. At least one perpetrator is an employee. Example includes, falsifying personal details for personal gain, theft of bank assets and unauthorized use of computer systems for fraudulent activities.
External fraud	Losses due to acts that intended to defraud, and misappropriate property by a third party. It includes hacking by third party, theft of information and forgery or impersonation.

Loss Types	Event
Employment practices and workplace safety	Losses arising from acts inconsistent with employment, health or safety laws or agreement, or from payment of personal injury claims or from diversity and discrimination events. For example failure to adhere to equal opportunity policies such as religion, sex, age and race.
Client products and business practices	Losses arising from an unintentional or negligent failure to meet a professional obligation to specific client, improper market practice and product flaws. It includes regulatory fines, customer complaints and breach of Anti Money Laundering Act.
Accidents and disasters	Losses arising from loss or damage to physical assets from natural disaster or accidents.
System failures	Losses arising from disruption of business or system failures such as hardware fault, telecommunication failure, and utility outage that can cause business disruption.
Execution delivery and process management	Losses from failed transaction processing or process management and involving no act aimed at benefiting or causing a loss for any party. It includes, data entry error, system errors in transaction process, ineffective documentation of processes, failure to provide accurate external reporting, failure to ensure effective contract documents, inaccurate customer records, incomplete mandatory reporting and poor management decisions or oversight.

Adapted from, "Operational Risk Transfer Across Financial Sectors", by Basel Committee, on Banking Supervision the Joint Forum, 2003, p. 31.

Currently, the Basel Committee framework provides three approaches for the operational risk capital charge measurement. The straightforward approach is the Basic Indicator Approach (BIA), by which the capital charge is calculated as a percentage (alpha) of Gross Income (GI), a proxy for operational risk exposure. Being the most basic approach, its adoption does not require prior supervisory approval. The most advanced methodology is the advanced measurement approaches (AMA), which allows banks to use internal models to calculate their capital requirements. Adoption of the AMA requires prior supervisory approval and involves implementation of a rigorous risk management framework. The third approach, the Standardized Approach (TSA), which is positioned as an intermediate approach between the BIA and the AMA, requires banks to divide their total GI into eight business lines

and to calculate capital requirements as a sum of the products of the GI attributed to each business line and the specific regulatory coefficients (betas) assigned to each line. Since the adoption of the TSA requires compliance with a set of qualitative criteria relating to operational risk management systems, banks are required to obtain prior approval from their supervisory authorities before moving to this approach. A variant of the TSA, the Alternative Standardized Approach (ASA), allows banks with high interest margins to calculate their operational risk capital requirements by replacing the GI for two business lines – retail banking and commercial banking – with a fixed percentage of their loans and advances. Adoption of the ASA is allowed by the respective supervisory authorities at their national discretion (Basel Committee, 2014).

2.1.1. Internal Fraud

Banking industry is one of the industries that is highly expose to internal fraud (Kingsley, 2012). According to the Association of Certified Fraud Examiners (ACFE) as mentioned by DiNapoli (2008), internal fraud can be defined as the use of one's (employee) profession for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets. Internal fraud involves with a range of irregularities and unlawful acts characterized by intentional deception. The five elements of internal fraud are:

- A representation about a material fact, which is false,
- Made intentionally, knowingly, or recklessly,
- Which is believed,
- And acted upon by the victim,
- To the victim's damage.

According to Duffield and Grabowsky (2001), the act of committing internal fraud is due to the factors such as a supply of motivated offenders, the availability of suitable targets, and the absence of capable guardians or a control system to "mind the store." DiNapoli (2008) stated that there are four factors that can lead an employee to commit internal fraud which includes opportunity, low chance of getting caught, rationalization in the fraudsters mind, and justification that are resulted from the rationalization. Cressy (1953) developed "The Triangle Fraud" to describe and explain the nature of fraud. "The Fraud Triangle" is depicted in the following figure 1:

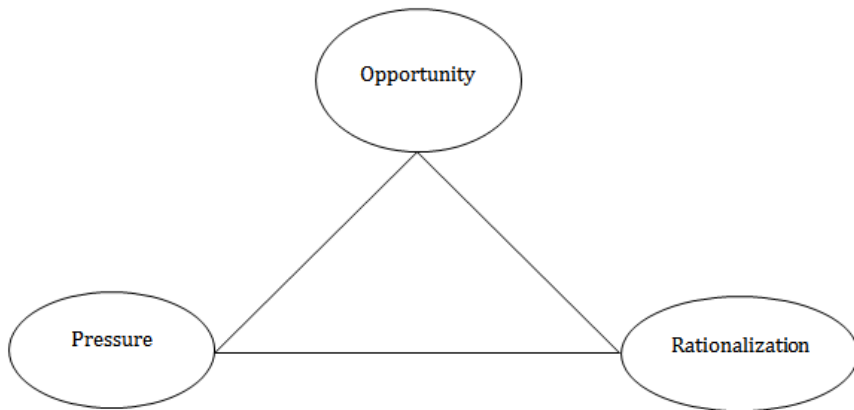


Figure 1. The Triangle Fraud. Adapted from “Other People’s Money: A Study in the Social Psychology of Embezzlement”, Cressey, D.R. 1953, Free Press, Glencoe, Illinois.

From figure 1, opportunity can be described as an open door for solving a non-shareable problem in secret by violating a trust. Opportunity is generally provided through weaknesses in the internal controls. Some examples include inadequate or lapses in supervision and review, separation of duties, management approval and system controls.

Pressure can be described as anything from unrealistic deadlines and performance goals to personal vices such as gambling or drugs. While rationalization is a crucial component of most frauds because most people need to align their behavior with the commonly accepted concepts of decency and trust.

In Malaysian banks, internal fraud usually involves with employee/s stealing cash or cash equivalents such as cashiers order or bank draft. Besides, internal fraud can be committed through the use of accounting entry. Employee with specific position may have privileged access to suspense accounts or accounts payable, which is temporarily function as interdepartmental transfers, cash in transit or loans in process. Internal fraud is also known as occupational fraud and insider abuse. If the types of fraud are considered, it ranges from identity theft, cheque fraud, counterfeit negotiable instruments, mortgage fraud, loan fraud, asset misappropriation, corruption, money laundering, credit card fraud and etc. (Zuraidah Mohd Sanusi et al., 2015)

2.2. Operational Risk Management in Banks

Operational Risk Management contains the mechanisms, tools, policies, procedures and processes, including management oversight, to identify, assess, monitor, report, and control operational risk. Taking into consideration the losses suffered in previous years, the banks has established operational risk management as the main objectives: a higher capital profitability, a better capital allocation, the avoidance of the unanticipated losses, the avoidance of a big number of losses of small value, the improvement of the operational efficiency; a higher attention for the operational risk during the banking management process; the increase of the services quality for the clients; an efficient information and human resources management (Nicoleta & Cornelia, 2007). However, operational risk management is not a new idea but what is new is the organization of the mechanisms of operational risk in a coherent and structured framework to accelerate the efficiency of the operational risk management (Bodla & Verma, 2008).

Moazinezhad et al, 2012, stated that the paradigm or model of risk management consist of a set of tasks which are a subsequence of chained activities throughout the lifecycle of a mission. Activities include:

- Activity 1: Identifying risks
Investigating and detecting risks, before they turn to problems.
- Activity 2: Analysis
The conversion of risk data into useful decision-making information. Evaluation of the impact levels, the likelihood and time limit of risk, classifying, and prioritizing them.
- Activity 3: Planning
Compiling the risk data to decisions of current and future activities and applying them.
- Activity 4: Tracking
Scrutiny of risk indices and reducing activities.
- Activity 5: Control
Reform of deviations toward reducing-risk programs.
- Activity 6: Communications
Information and feedback from external and internal risk activities provides existed and arisen risks.

Basel Committee (2014) has set expectations for the implementation of the operational risk management. All internationally active banks should implement policies, procedures and practices to manage operational risk according to their size, complexity, activities and risk exposure, and seek continuous improvement in these areas as industry practice evolves. In order to enhance operational risk management, the committee provide comprehensive guidance regarding the qualitative standards that should be observed by large internationally active banks. The Committee considers it appropriate to achieve more definitive, rigorous and comprehensive implementation of operational risk management by setting out specific guidance to be followed by large internationally active banks.

Bank Negara Malaysia (BNM) has placed great emphasis on risk management. The ultimate aims are to enable operative and effective delivery on the mandates of banks while safeguarding the assets and reputation of banks. Therefore, BNM continued to strengthen its risk management governance framework to ensure that it is adequately strong to face the challenges ahead. BNM also undertook initiatives to further enhance its risk management culture, including further embedding risk management processes into all strategic initiatives, policy making and operations of banks. The overall framework sets out the general principles and processes to ensure consistent and effective management and oversight of risks in the Bank. Operational Risk Management and Financial Risk Management frameworks are designed to provide greater transparency in managing specific risk types. Greater efforts were made towards creating increased clarity across the organization about risk events that could impact bank's reputation. This would enable banks to develop a more systematic approach in understanding the nature of the specific reputational risk event and direct resources to address the root causes. A key component in this initiative is the formulation of the Stakeholder Engagement Framework. BNM foresees greater challenges in managing the risks that are dynamic in nature as well as in building the right risk management culture. Therefore, BNM has developed an Operational Risk Reporting System to Report any operational risk event and loss reporting system, for increased surveillance capability as well as for information sharing with the industry. This system has been in operation since January 2013 and has been acknowledged by World Bank and International Monetary Fund (www.bnm.my).

2.3. Business Ethics in Banks

According to Velasquez (2012), business ethics is a study of right and wrong that are applied to business policies, institutions, and behaviors. This is an important study due to the nature of business as the most influential institutions within modern society. Besides, business organizations are the primary economic institutions through which people in modern societies carry out the tasks of producing and distributing goods and services. They provide the fundamental structures within which the members of society combine their scarce resources—land, labor, capital, and technology—into usable goods, and they provide the channels through which these goods are distributed in the form of consumer products, employee salaries, investors' return, and government taxes. Though business ethics cover a variety of topics, there are three basic types of issues:

1. Systemic issues — Related to the economic, political, legal, or other social systems in which businesses operate. These include questions about the morality of capitalism or of the laws, regulations, industrial structures, and social practices within which businesses operate.

2. Corporate issues — Related to a particular company. These include questions about the morality of the activities, policies, practices, or organizational structure of a company.

3. Individual issues — Related to a particular individual within an organization and their behaviors and decisions. These include questions about the morality of the decisions, actions, or character of an individual.

Organizations and business people who thrive for sustainability must practice sound ethical decision-making. Organizations and people who behave in a socially responsible manner will enjoy the greatest success as compared to those whose actions are solely motivated by profits. Knowing the difference between right and wrong and choosing what is right is the foundation of ethical decision making in business. Thus, doing the right thing often leads to the greatest financial, social, and personal rewards in the long term (Hejase et al., 2013).

The banking industry proved that success can be achieved by incorporating high ethical standards when delivering quality services, good customer service, management duties, staff qualifications, and the staff appreciation of their work. Failure to follow ethical norms and lack of

business transparency were among the reasons that lead to the global financial crisis. Confidence in banks is the key to success. It is indeed a challenging task in ensuring the safety of the banking activities. The ongoing processes of global integration, internationalization, and continuous financial innovations directly affecting banking operations. As a result, the solution to the banks' problems rest on the attitude and confidence of the market players. Among other things, the rating of confidence in banks greatly depends on skilled supervision (Jasevičienė, 2012).

Svensson and Wood (2008) introduced business ethics dimensions that include three components: society expectation, organizational culture and society evaluations. The components contributes to the creation of a conceptual framework of business ethics. The components can be affected by people behaviors and perceptions. The outcomes of the framework are determined by the evolution of time and contexts. A few tentative conclusions may be drawn from the dimensions.

2.4. Machiavellianism

Machiavellianism personality traits are first introduced by Niccolo Machiavelli's (1532/1950), the author of *The Prince*. The book acts as a guidance for those attempting to seize and retain political power. His ideas were based on historical events rather than philosophical idea. He suggested that even a morally righteous man must make deliberate use of ruthless, amoral, and deceptive methods when dealing with unscrupulous men. The Machiavellian personality is defined by three sets of interrelated values: an avowed belief in the effectiveness of manipulative tactics in dealing with other people (e.g., "Never tell anyone the real reason you did something unless it is useful to do so"), a cynical view of human nature (e.g., "It is safest to assume that all people have a vicious streak and it will come out when they are given a chance"), and a moral outlook that puts expediency above principle (e.g., "It is hard to get ahead without cutting corners here and there") (O'Boyle et al., 2012). Machiavellians individuals are emotionless, realistic, and have skeptical perspective on life and interpersonal relationships that justified their behaviors in exploiting others and acting in immoral ways (Rauthman, 2012).

O'Boyle et al., (2012) stated that Machiavellians individuals are successful in their careers, especially when they are working in unstructured

and less organized settings. However, as the organizational structure increases, their success tends to decline. Machiavellians will be less productive and are more likely to display negative workplace behaviors no matter what their level of authority or the degree of collectivism in the organization where they worked. However, Machiavellians do not regularly engage in extremely negative forms of antisocial behavior (Jones & Paulhus, 2009).

2.5. The Relationship between Business Ethics and Operational Risk Management

Business ethics acts as a governance for a good operational risk management. The components of business ethics that include: society expects; organizational culture; and society evaluations provide the foundations in managing operational risk in banks. Thus the paper hypothesized the relationship as follow:

H1: The higher the business ethics the better the operational risk management.

2.5.1. Society Expectation and Operational Risk Management

Society have high expectations towards business and the business leaders (Svennson & Wood, 2008). Thus customers expected banks to protect their deposits. Customers trust are important for banks sustainability. Banks are the custodian of customers' money and investment while employees acting on behalf of bank management in performing their services to the customers. Socially responsible managers will ensure that their actions are appropriate and truthful as expected by the society (Svennson & Wood, 2008). Thus, it is the responsibility of the banks to develop good operational risk management in mitigating risk and gain trust from customers. Besides, shareholders are also part of the society and investors of the organization. Shareholders invest in an organization they trust. Many cases involving shareholders being cheated by executives who end up collapsing the organizations and escaping with the illegal gain. Shareholders deserve organizations that protect them because they are entitled to a return on investment at the market rates or better. If such returns are not forthcoming, then open and early disclosure is required to enable shareholders to be able to assess their own positions. Good organizations do this for all shareholders

regardless of institutional shareholders or others. The welfare of all shareholders should be treated equally regardless of the size of the shares that they own (Svennson & Wood, 2008). Hence, the relationship is hypothesized as follow:

H1a: The higher the society expectation the better the operational risk management.

2.5.2. Organizational Culture and Operational Risk Management

Organizational culture is very important for an organization (Svennson & Wood, 2008). It is the “set theory” of important values, beliefs, and understandings that members share in common, that provides better (or the best) ways of thinking, feeling and reacting that could help managers to make decision and arrange activities of organization. A successful organization should have strong cultures that can attract, hold, and reward people for performing roles and achieving goals. Strong cultures are usually characterized by dedication and co-operation in the name of common values in order to overcome problems or challenges in the organizations (Sun, 2009). Operational risk is therefore a major problem and threat to the banks. One of the banks objective is to manage risk. Good organizational culture is the foundation of a good operational risk management. Hence, the relationship is hypothesized as follow:

H1b: The better the organizational culture the higher the operational risk management.

2.5.3. Society Evaluations and Operational Risk management

There are standards that members of society use in evaluating the performance of an organization. In many cases, this evaluation is not a conscious one, but one that develops as one is made aware of incongruities and inconsistencies in the ways in which for example the organizations profit has been achieved. The questions at the center of these issues include: What have been the economic outcomes of their actions?; Has their behavior been lawful?; Are they better corporate citizens than they were?; Have they paid the appropriate taxes?; Has the company been environmentally friendly?; Have they retained good employees?; Have services to customers been retained?; Are their products acceptable to us from a health and safety perspective? (Svennson & Wood, 2008). Therefore,

banks must prove to the customers that they are highly responsible and proactive or reactive to customers' needs and demands. Hence, the relationship is hypothesized as follow:

H1c: The higher the society evaluations the higher the operational risk management.

2.6. Machiavellianism Personality Traits as a Moderator

Previous studies have found that Machiavellianism personality traits has a moderating effect, although studies are not on the issue of banks operational risk management. In a study done by Wei and Chen (2011) among 216 middle school 7th-graders in Taipei, Taiwan on the relationships between bullying, peer acceptance, and school adjustment (rule-following behavior and academic performance), it was found that The participants were divided into two groups according to their Machiavellianism. Analysis showed that for those who were low in Machiavellianism condition, physical and verbal bullying was negatively linked to peer acceptance and academic performance while no significant association was found for the high-Machiavellianism group. Bullying was negatively, yet non-significantly, associated with rule-following behavior for both groups. The results largely supported the moderating effect of Machiavellianism on the negative outcomes of bullying. Hartog and Belschank (2012) in a study done on work engagement and Machiavellianism in the ethical leadership process also found the moderating effect of Machiavellianism. The notion that Machiavellianism as the moderator is supported because it was found that the effects of ethical behavior on engagement are less strong when ethical leaders are high as opposed to low on Machiavellianism. Based on the literature, the paper hypothesized as follow:

H2: Machiavellianism moderates the relationship between business ethics and operational risk management.

2.7. Agency Theory

In the paper, agency theory is use to explain the relationship between business ethics and operational risk management. The origin of agency theory can be traced back to its roots in information economics (Eisendhart, 1989). Agency theory is related to the universal agency relationship between one party (the principal) who delegates work to another (the agent),

who in turn performs the delegated task. Agency theory ultimate priority is to resolve problems that can occur in agency relationships. Agency problem includes; (i) the desires or goals of the principal and agent conflict and (ii) it is difficult or expensive for the principal to verify what is currently been done by the agent. The main problem is that the principal and the agent may prefer different actions because of the different risk preferences (Eisendhart, 1989). Thus business ethics act as the principal and operational risk management is the agent.

According to Sheedy (1999), agency risks are correlated with information asymmetry and agency problems mostly happen in a large public company. Failure by agents to act in accordance to the interests of principals covers a wide range of behavior which includes avoidance, carelessness, and inappropriate decisions (Sheedy, 1999). In financial institutions, operational or agency risk can be managed using an agency framework. It is because operational or agency risk is the main cause of operational losses. The risk includes breaches of company policy, incomplete information and poor management decisions (Sheedy, 1999). Therefore, agency theory not only helps to identify situations where agency risk is high but also suggests principles for the problem reduction through effective organizational structures (Sheedy, 1999).

2.8. Machiavelli Intelligence Theory

The Machiavellian intelligence theory (or the “social brain” hypothesis) postulates that large brains and unique cognitive abilities of humans have evolved via intense social competition in which social competitors developed increasingly sophisticated “Machiavellian” strategies as ways to achieve higher social and reproductive success (Gavrilets and Vose, 2006). According to this hypothesis, one of the important increasing pressures on human cognition is the risk of manipulation and deception. Manipulation and counter-measures to manipulation evolved in an “arms race” that led to greater intelligence. That is, as the social intellect in some members of a community increase, so will the application of selection pressures on others to show their social capability, thus resulting in the “arms race” of our Machiavellian intelligence over time (Santhalingham, 2009). Thus, the Machiavellianism intelligence theory clearly explained the reasons behind those internal fraud cases in banking industry as depicted by the unethical behavior of Nick Leeson and Tan Khay Guan.

3. Proposed Conceptual Framework

Based from the literature review and the underpinning theories, the paper proposed a conceptual framework. It is depicted in the following figure 2.

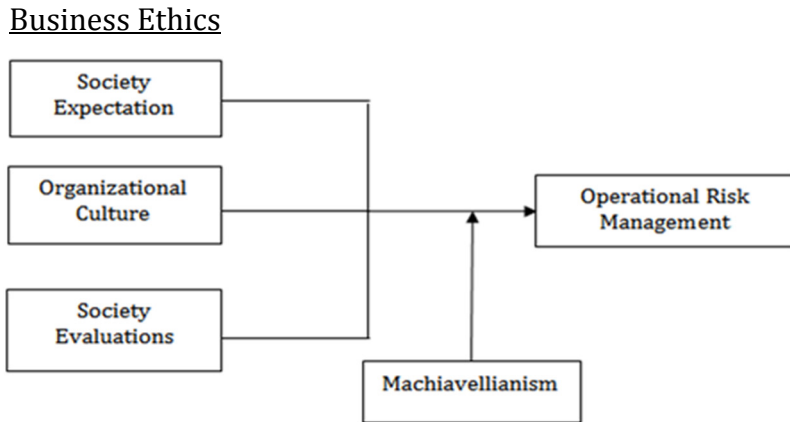


Figure 2. Proposed Conceptual Framework

From figure 2, business ethics dimensions (society expectation, organizational culture and society evaluations) become the independent variables while operational risk management is the dependent variable. Machiavellianism act as the moderator in the relationship between business ethics and operational risk management.

4. Limitation and Future Research

Like most papers, the author has found some limitations. Firstly the paper only concentrated in the banking industry. It is due to the wide range of operational risk and losses faced by the banks. Secondly, the paper concentrated on managing operational risk that is related to internal fraud because the impacts and losses can leads to high losses and even the collapse of a bank as depicted in the Baring Banks and SocieteGeneral cases. Lastly, there are other variables that are not taken into consideration such as the quality of banks human resources and the internal control system. Future research can be done on the antecedent and outcome of operational

risk management with business ethics as the antecedent of operational risk management and internal fraud as the outcome of operational risk management. Besides, future research on business ethics and operational risk management can be done in other industry such as education, manufacturing or logistic industries.

5. Conclusions

It is hope that the paper will shed some lights on operational risk management and business ethics. The paper also highlighted on the Machiavellianism personality traits that are behind the internal fraud cases in banks. Based from the conceptual model, it is hope that banks could develop a robust operational risk management base on the dimensions of good business ethics. By including Machiavellianism variable as the moderator in the conceptual model, it will assists banks in identifying employees with high or low Machiavellianism personality traits. This is to ensure that the future risk of internal fraud occurrence can be eliminated. Furthermore, for future recruitment, banks might consider having personality test in identifying those applicants that might demonstrate high or low Machiavellianism when hired as bank employees.

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