Fraud in Times of Crisis

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The prevalence of fraud has increased with the diversification of businesses, the increase in the number of players, the growing complexity of business operations, and the globalization of the economy, but this does not necessarily mean that there is a mutually-dependent relationship between crisis and fraud.

It is not easy to pinpoint the type of relationship that exists between fraud and economic crises, or even to establish that as a result of such crises, more acts of fraud are committed, as is often the generalization. Fraud and the activities associated with it are an inherent part of economic activity and human behavior.

By his very nature, man is constantly testing the limits, and if he finds that there is no individual or rule to define those limits, then he will continue to test them until someone or something takes control of the situation, until a rule is created or put in place, or until the cycle is broken (or his luck runs out).

Examples relevant to the subject of this work can be found in the establishment and enforcement of regulations such as the Sarbanes-Oxley Act of 2002 (after Enron), the Foreign Corrupt Practices Act (FCPA), or the Markets in Financial Instruments Directive (MiFID).

Precisely because cycles are a part of economic dynamics, we can presume a relationship between fraud and crises, not because a crisis or crises have arisen as a result of any act of fraud in particular, but rather because as a result of crises, business and/or financial practices have been identified which are either currently being questioned or are already considered to be fraudulent.

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ECONOMÍA EXTERIOR. Number 48. Spring 2009.

Just like once the tide goes out, everyone can see who's been swimming naked, when economic cycles change, abuses are uncovered, as are their victims and their perpetrators.

Symmetry of information: a concept that is difficult to quantify

Although the existence of fraud dates back to the beginning of business relationships, rarely has this topic or its relationship to crisis situations been written about. The economist Charles Kindleberger has been one of the authors to devote his time to analyzing the possible connections that exist.

In one of his best-known books, *Manias, Panics and Crashes: A History of Financial Crises*, Kindleberger notes that "Fraud is an iceberg: only a part of the act is known to the public ... fraud and statistics simply make poor companions."[1]

In this sense, the available information on cases of fraud and their effects on the economy is limited and mainly tends to focus on only one part of the problem: corporate fraud that is either highly publicized or has a significant effect on the markets.

Companies and their administrators are generally reluctant to provide information about fraud, or possible cases of fraud, committed in their organization. As an example of this phenomenon, the majority of studies carried out on this topic have a response rate of 10%-15% of those surveyed.

While these analyses allow us to identify practices, effects, and potential solutions, they fail to provide us with the information needed to be able to address fraud in its entirety and to make inferences regarding its causes, its total effect on the economy, and its relationship—or lack thereof—to economic cycles.

For example, the Association of Certified Fraud Examiners (ACFE) has indicated that the level of fraud in 2006 represented 6% of the GDP of the United States in that year and 5% in 2008. These numbers, however, only include what is referred to as "occupational fraud."[2]

Moreover, one of the most recent studies conducted by the European Anti-Fraud Office (OLAF, based on its initials in French) only makes reference to citizens' perception of fraud concerning public funds in the European Union. Seven out of ten people questioned

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1. Charles Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises*. Hoboken: John Wiley & Sons, 2005, fifth edition.

2. Occupational fraud refers to the use of one's position within an organization to intentionally use the company's resources for one's own benefit. Included within this category are misappropriation of assets, corruption, and fraudulent financial statements.

believe that there is fraud involved in their country's use of public funds.[3] And from there, one could continue to analyze information from the national prosecutor's office of each country, from their financial offices, and from a long list of bodies and institutions that only provide data from their particular area of responsibility.

What is certain is that forms of fraud and fraudulent practices have been on the rise. Actions that in the past were not considered fraudulent—conflicts of interest, insider trading (i.e., the use of privileged information), the valuation of specific assets—are today penalized and regulated. In this sense, we can say that the types of fraud have increased as businesses have diversified, the number of stakeholders has increased, the complexity of operations has grown, and the economy has become globalized.

If we add to this mixture technological advancement and the ever-increasing use of technology in business relations, we can understand how their interaction has allowed, or even encouraged, the development of new business practices (fraudulent or not) to outpace the advance of new regulations. As a result, in the majority of cases, the regulating entities remain one step behind current business practices.

This legal void and/or a potential laxity of controls—which tend to focus on quasi-self-regulation—have increased the impact of conduct determined to be fraudulent, or the abuse of conduct which up to this point has been considered legal, and can have a direct influence on changes in cycles and the emergence of crises.

In his article "Crisis and Fraud," the head of investments at Crédit Agricole, Pascal Blanqué, noted that "In every credit bubble, fraud and crisis start out as a period of ecstasy but come to an unhappy end because the authorities lose sight of the fact that their policies have a delayed effect…"[4]

It would appear, then, that we are confronted with a mutually-dependent relationship, but the truth is that fraud is far removed from that relationship, and each situation must be analyzed on its own.

Does a cause and effect relationship exist?

The current market situation, the economy in general, and the facts that have come to light since the middle of 2008 reveal not only that

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3. Citizens' perceptions of fraud and the fight against fraud in the EU27. Brussels: OLAF, October, 2008.

4. Pascal Blanqué, "Crisis and Fraud," *Journal of Financial Regulation and Compliance*. Bingley: MCB UP, 2003, vol. 11, pp. 60-70.

abuses have taken place in several sectors, but also that business practices exist that, either directly or indirectly, have contributed to this situation—a situation which we do not yet know whether is nearing an end or is only just getting started.

Positing a cause and effect relationship requires us to distinguish between the various types of fraud which can exist and affect different players in business relationships. Not all economic bubbles are synonymous with fraud, and not all acts of fraud generate crises.

Examples of fraud include the Barings Bank case in 1995, Long Term Capital Markets in 1999, Société Génerale in 2008, or, in Spain, the GesCartera case and the investigations into Forum Filatelico y Afinsa, *inter alia*. Moreover, other instances of fraud of lesser notoriety which are independent of the economic cycle pose a daily challenge to organizations due to the nature of their operations and may not have a direct connection to the existence of a crisis.

If credit had not dried up and investors had not demanded their money back, there might have never been a 'Madoff case.'

Nevertheless, we can observe certain common denominators in the stages leading up to the economic crisis of 1929, the technology bubble of 2000-2001, and the current crisis: periods of monetary expansion, low interest rates, almost unlimited access to credit, low inflation, and minimal intervention by the state. In all of these cases, these factors have led to the identification of fraud and, as described above, to practices which had not previously been considered abusive or fraudulent.

As far as the Madoff case and the ensuing loss of 50 billion dollars are concerned, if market conditions had not restricted access to credit and if investors had not demanded their money back, the model might have continued indefinitely. The Satyam Computer Services case and the improper capitalization of expenses, along with the inclusion of non-existent assets of one billion dollars, may never have come to light if access to credit had not been restricted and trading margins limited. This leads us to a sort of *déjà vu*, given what occurred in 2001-2003 when the Enron, MCI WorldCom, and Parmalat cases were uncovered.

What, then, leads us to posit this comparison? We believe that the relationship that exists between crisis and fraud may result from the development of new financial instruments that have gradually entered the credit market and been traded during cycles of growth. Such instruments have, by their very nature, facilitated a nearly unlimited quest for profit and, as former Federal Reserve Chairman Alan Greenspan pointed out, have been fueled by an infectious greed—a greed which, in the face of the possibility of easy wealth, has undermined the foundations of the economic system.

This greed began to take shape with the delivery of mortgage loans to persons of limited means, with the packaging of mortgages into CDOs (collateralized debt obligations), with the increase in hedge fund activities, with banks selling their loan portfolios in search of additional funds in order to be able to issue more credit, with insurance companies issuing policies to cover CDOs, with auditors providing favorable opinions on the soundness of the transactions, with the rating agencies in charge of evaluating the financial instruments, and with the desire to continue with a cycle of activities that was promoting the idea that resources, funds, and profits were unlimited.

However, with the end of the cycle drawing near, the drive to continue profiting and/or to cover previously-executed transactions caused some to cross the line of what was legally acceptable and led to practices which, fueled by greed, were intended to cover positions which could have negatively affected operations, earnings, and profits.

In other words, the mortgage fraud that took place in the United States in 2007 was an alarm signaling that the end of the cycle was approaching, while the events of 2008 served to confirm that the economic expansion had reached an end. And, as history tends to repeat itself, 2009 may surprise us with new forms of fraud similar to those that emerged during and were identified after the crises of 1997 and 2001.[5]

Thus, fraud does not cause crisis. Unfortunately, though, some fraud is inherent to business activities and industry, while other types of fraud—the most dangerous ones—arise during periods of economic expansion or positive economic cycles, increase as the growth stabilizes, worsen when the crisis begins, and produce a reality shock leading to panic when the fraudulent acts are uncovered.

Are we losing our principles?

In one of his works, the economist John Kenneth Galbraith wrote that "the man who is admired for the ingenuity of his larceny is almost always rediscovering some earlier form of fraud. The basic forms are all known, have all been practiced. The manners of capitalism improve. The morals may not."

5. It should be noted that the end of the cycle was accompanied by low interest rates, monetary expansion, high rates of consumption, increased financing, and a high propensity for risk taking.

One common factor in the identification of cases of fraud is the attempt to continuously earn profit, and profit cannot be separated from the element of risk. The information available, regulations, and control mechanisms will determine the tolerance for risk that one is willing to accept in order to realize a certain profit.

Were credit growth rates upwards of 15% during three consecutive periods reasonable? Was it wise for the number of new housing units to increase exponentially from 2004 to 2007? Was it sustainable for Bernard Madoff to provide returns of more than 10% while the market was paying less than 5%? Was it logical that returns on investments in real estate were greater than those on investments in public companies?

The unyielding search for profit to meet the expectations of consumers, shareholders, and investors has caused certain practices—once maximized by a greater aversion to risk and seen as fruit of the returns offered by the market—to now be questioned. Consequently, we now find ourselves in a situation where it would appear that fraud is, finally, one of the costs of having interacted with new business practices in a more global market with nearly unlimited borders.

This cost may have increased due to the absence of regulation, whether internal—on the part of the companies—or on the part of the government, by turning a blind eye to debt ratios, failing to directly regulate new financial products, ignoring what was taking place thanks to the blindness caused by the boom in which we found ourselves, or by the continuous task of pushing the bar higher and staying current with novel financial products that were difficult to regulate. Nevertheless, this is reasonable when we consider that the information on risk was also in some ways unfounded. Estimating and quantifying risk continues to be as difficult and complex as finding a cure to cancer. However, information on risk gets obscured when it is turned into into a financial instrument, which then gets mixed with other risks and other instruments, which finally all end up being securitized.

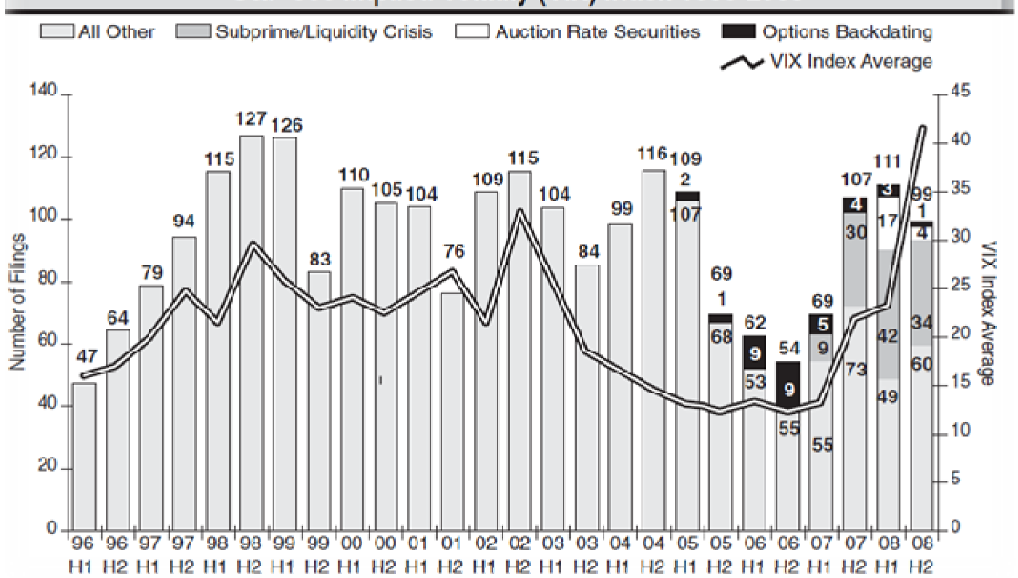
These connections explain why the effects of the financial crisis been so severe and widespread. The situations identified above have undermined the foundations of business relationships, the quality of information, and confidence in the players. If fraud is defined as the loss of confidence and abuse, then we find ourselves in a situation where we do not know what information is reliable, who is solvent, or what the nature of guaranteed assets is—not because we have lost our basic principles, but because the expansion of the markets and globalization have created new territory where regulatory limits have yet to be drawn.

Pandora's box: Will more cases of fraud come to light?

We still do not know what the real effect of the crisis will be. The United States government has set aside 53 billion dollars to save Fannie Mae and Freddie Mac. It has done the same for AIG and is now analyzing the Citigroup situation. In Europe, Germany has rescued Commerzbank, the United Kingdom has bailed out Northern Rock, Austria has saved Constantia Privatbank, and the list goes on. Spain, the country that has seen the greatest growth in the housing sector in all of Europe—and one of the countries with the worst outlooks for 2009—is surprising in that it has not yet had to come to the rescue of a single financial institution. While we hope that this will not become necessary, it could indicate that we still have a long road ahead of us before we can fully appreciate the depth of this crisis.

Now is not the time to create more uncertainty. However, it is the time to make the real position of businesses clear so that they can appreciate the reality of the situation using precise information, know where greater regulation is needed, and, finally, estimate the real risk of their operations.

CAF IndexTM-Semiannual Number of Class Action Filings and S&P 500 Implied Volatily (VIX) Index 1996-2008



Source: Cornerstone Research.

S&P 500 Securities Litigation Heat Maps™
Percent of Companies Subject to New Filings 200-2008

Legend: 0% | 0% - 5% | 5% - 15% | 15% - 25% | + 25%

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Basic Materials	2,4%	0,0%	0,0%	0,0%	0,0%	3,4%	0,0%	0,0%	0,0%
Communications	8,3%	17,4%	22,7%	4,8%	2,3%	4,8%	2,3%	6,5%	4,8%
Consumer Cyclical	5,5%	4,1%	5,3%	5,5%	2,7%	9,5%	2,8%	5,9%	2,9%
Consumer Non-Cyclical	4,5%	5,6%	9,7%	7,4%	8,4%	9,6%	7,1%	9,3%	7,4%
Energy	0,0%	3,3%	19,2%	0,0%	4,0%	0,0%	0,0%	0,0%	0,0%
Financial	4,2%	1,4%	18,3%	6,3%	13,6%	5,0%	0,0%	9,4%	32,6%
Industrial	2,9%	0,0%	6,1%	4,5%	4,5%	4,6%	1,6%	1,6%	3,2%
Technology	11,4%	14,8%	5,3%	3,6%	3,6%	5,4%	9,3%	0,0%	6,0%
Utilities	5,9%	5,9%	34,3%	2,9%	6,1%	3,0%	0,0%	3,2%	3,3%
All S&P 500 Companies	5,0%	5,6%	12,0%	4,8%	6,0%	6,0%	3,2%	5,2%	9,2%

* The chart is based on the composition of the S&P 500 as of the first trading day of each year. Industries are based on Bicomberg sector classifications. Precent of Companies Subject to New Filings equals the number of companies subject to new securities class action filings in federal courts in each sector divided by the total number of companies in that sector.

Source: Cornerstone Research.

The process of cleaning house has begun. The reduction of margins and volumes has led to stricter controls of business operations, and this will in turn reveal abuses, not only at the global level, but in individual businesses, regardless of their size. Some cases of fraud have already been exposed, such as the "Indian Enron" (Satyam), the previously-mentioned Madoff case, and Asia Media in China.

In order to take a glimpse at what 2009 has in store for us, we need only look to the findings of *Securities Class Action Filings, 2008: A Year in Review*, a study carried out by the Stanford Law School and Cornerstone Research which reports that the year 2008 was dominated by lawsuits filed by special interest groups against financial services firms in the United States. This situation is comparable to the number of lawsuits filed against technology firms, energy companies, and public utilities from 2001 to 2004, the period when the frauds that have had the greatest impact on the markets in recent years were uncovered.

This entire analysis further demonstrates the direct connection that exists among the industries that have been a part of the market bubble, their volatility, and the number of lawsuits filed against them and their executives as a result of questionable practices.

So, what can we expect for the future? At the micro level, we would need to know the status of the banks' portfolios, the real value of real estate assets and investments in commodities, and the soundness of investment funds with high guaranteed rates of return. It would also be essential to analyze operations involving renewable energies and the buying and selling of $C0_2$ credits. These activities have grown exponentially in recent years, the market is fragmented, and their regulatory framework is even less developed.

And finally, we come to the staple of all crises: fraudulent manipulation of financial statements. The need to generate profits, a shortage of credit, and a lack of liquidity are the perfect recipe for pressuring companies to show favorable results while encouraging regulators to loosen the reins. Special attention will need to be placed on companies in emerging markets such as China and India which, in addition to the growth they have experienced in recent years, have seen high volumes of investment from multinationals, venture capitalists, and/or expanding companies. Investment demands returns, and faced with an economic slowdown, returns can result in accounting sleight of hand. In game theory, specifically in the prisoners' dilemma, two players are willing to cooperate and maximize their payoffs or minimize their losses. We will see who's been swimming naked.