TWENTY-EIGHTH INTERNATIONAL SYMPOSIUM ON ECONOMIC CRIME

“The New Deal – ensuring integrity, stability and survival”

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THE FINANCIAL CRISIS – A PERSPECTIVE ON CAUSE AND EFFECT

"zero down, no interest, no payments for 18 months!"

The author does not purport to be an economist, nor an accountant, but will offer a perspective on the cause and effect of the "Financial Crisis" from a law enforcement point of view. To begin, the author will assert the financial crisis was not directly caused by crime. However, sophisticated economic crime did aid and abet the financial crisis. And, the crisis had the effect of revealing significant financial crimes.

US Regulation Change Created Demand for Debt Instruments

One can read where it was back in April, 2004 that the Securities & Exchange Commission in the United States modified what is known as their 'net capital' rule. It is thought by many that this was the beginning - as it immediately freed up billions of dollars held in reserve by the big investment banks as a cushion against losses on their investments. These banks were then able to invest in mortgage-backed securities and credit derivatives.

In late 2007, there were about six million people in the United States who had no money and borrowed about 100% of the value of a house, right at the top of a housing market[1]. These were the subprime borrowers. However, the lenders had not worried about the risk of default, because the mortgages had been rolled into bonds called Mortgage-Backed Securities, which they had then sold. In this way,

[1] Paul Tustain, "Subprime mortgage collapse: why Bear Stearns is just the start", Money Week, Sep. 05, 2007, http://www.moneyweek.com/investment-advice/how-to-invest/subprime-mortgage-collapse-why-bear-stearns-is-just-the-start.aspx [Accessed Sep. 01, 2010].

they got to be off-risk within a few weeks, because by then these re-packaged mortgages belonged to other financial organizations.

Asset-Backed Commercial Paper (ABCP) is very similar in that it is corporate debt that is due within a year and is backed by assets such as real estate, vehicles and other commercial assets. Quite simply, this is another package of loans that is resold to other investors.

Both of these collateralized debt obligations were created to provide more liquidity in the economy by allowing banks and corporations to sell off debt, which frees up more capital to invest or loan. However, the downside of these types of debt obligation is that they allow the originators of the loans to avoid having to collect on the loans when they become due, since the loans are now owned by other investors. Now here is where the whole deal begins to smell. There was no incentive to adhere to lending standards. These subprime mortgages became known as NINJA loans - "**No Income, No Job or Assets**"[2]. They originated without the important documentation to prove that the applicant could reasonably adhere to the loan terms. Many of these loans were purportedly based on unsubstantiated lies from either the applicant or the mortgage broker, or from both. Regardless, the lender that ultimately approved the loan did so without exercising due diligence to ensure that the applicant could afford the mortgage.

One can see where this would make all of this debt quite susceptible to default and yet the only incentive would be to sell as much debt as possible. Hence, this early part of the economic crisis is referred to as the creation of the demand for debt.

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[2] Kenneth Long, "NINJA Loans to Blame for Financial Crisis", Vision Credit Education, Inc., Sep. 19, 2008, http://www.visioncredit.org/ninja-loans-to-blame-for-financial-crisis/ [Accessed Sep. 01, 2010].

The Collapse

In early 2008, as much as 80% of U.S. mortgages issued to subprime borrowers were adjustable rate mortgages[3]. When U.S. house prices began to decline, refinancing became more difficult. As adjustable-rate mortgages began to rise, mortgage delinquencies soared. Securities backed with subprime mortgages lost most of their value. The result was a large decline in the capital of many banks and U.S. government sponsored enterprises, tightening credit around the world.

The subprime crisis then, as this was all referred, came about because of financial instruments such as securitization. Banks would pool their various loans into sellable assets, thus off-loading risky loans onto others. The traditional way in which we know banks make money is in money-earning loans, but those are tied up for decades. So they were turned into securities. The security buyer gets regular payments from all those mortgages; the banker off loads the risk. **Securitization was seen as perhaps the greatest financial innovation in the 20th century.**

September 15, 2008 was the date recorded as the beginning of a major upheaval in the U.S. financial system as the stock market digested the significance of the problem. The Dow Jones industrial average lost more than 500 points, more than 4 percent, its steepest point drop since the day the stock market reopened after the September 11th attacks. **About $700 billion evaporated from retirement plans, government pension funds and other investment portfolios.**

Investors had essentially lost confidence in this form of securitization. The business model simply did not work.

[3] Senator Dodd, "Senator Dodd: Create, Sustain, Preserve, and Protect the American Dream of Home Ownership", Chris Dodd, Feb. 07, 2007, http://dodd.senate.gov/?q=node/3731 [Accessed Sep. 01, 2010].

In Canada, we watched the U.S. market with fascination. Our politicians continually assured us that our banks were well regulated. We did not change the 'net capital rule' and therefore there was nothing to worry about. Except, the collapse of those institutions holding the debt instruments caused some panic and resulted in a sell-off of all securities. And our own banks held significant positions of the high-risk securities. Canada's economy is largely resource based and therefore when the economic situation goes in the pot, the demand for resources drops and our own stock markets collapse.

The Bank of Canada cut interest rates and injected small amounts of cash into our financial sector in an effort to keep credit fluid. But there was no need for a $700-billion bank bailout, because our banks were not in trouble. They had largely avoided the international credit crunch because their loan portfolios were secure and their management practices sound. For the period 2005-2008, nearly one-quarter of home loans in the United States were made to high-risk borrowers -- mortgagees with questionable chances of paying back their loans. In Britain, that figure was 12% and in Canada, it was under 5%[4].

Let us focus a bit on the other willing participant in this scenario – the consumer. In today's consumer driven society we willingly amass debt as we are told that there is absolutely no reason to wait for something we can not immediately afford. The retail objective is to have us commit future income towards the purchase of something we just do not want to wait for. In similar fashion to how mortgage risk was sold off, the retailer can then download the risk as quickly as possible by selling the credit transaction to another company.

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[4] Editorial: "Our banks are safe", National Post, Oct. 09, 2008, http://www.nationalpost.com/opinion/story.html?id=868919 [Accessed Sep. 01, 2010].

It is this type of debt maximization encouragement, at both the consumer and corporate levels that really got us into trouble.

As governments worldwide strive to legislate a solution to high-risk debt by tightening lending rules, we should be asking ourselves what is it about our society today that makes us so different from our more prudent parents and forefathers? Some would argue it is because we have never lived through a great depression nor have we experienced real economic hardship. **We do not know why it is important to save for a rainy day – after all, haven't rainy days been replaced with overdraft protection and credit cards?** We do not know why we should not count on future income – we have never experienced total economic collapse.

Some financial experts might wish to remind us this process of maximizing consumer debt is in turn providing liquidity and is actually good for the economy. New instruments such as 'reverse mortgages' have been proven to un-tap the wealth of people who are holding onto the capital invested in their home and allowed that to be invested in additional income generating projects. Other similar lending instruments do a lot to stimulate the economy. This model works well in a strong, stable and robust market. However, as we have found out, and only too painfully, there is risk.

As the world economy went into recession every capitalist value was thrown out of the window in an attempt to stop the slide. The immediate response, in contrast to previous eras of unregulated free markets, was intervention on an unprecedented scale. Economic stimulus became the favoured key to recovery. Governments around the world announced immediate stimulus plans. The jury is still out with respect to the true overall impact of the trillions of dollars expended under this strategy. Taxpayers watched with great uneasiness as trillion dollar stimulus programs and billion dollar bailout packages were announced.

From a law enforcement perspective, it is only prudent to expect some of these funds may have fallen into the wrong hands and, as is quite common with those funds directed towards disaster relief, we should expect complaints of corruption, embezzlement and fraud. In an effort by governments to expedite the delivery of the stimulus packages, there were indications that they may have been prepared to overlook traditional rules, regulations and governance policies. The fear was that the economy would worsen before the stimulus money got out and that was considered a greater risk than having the "odd mistake" made[5]. Although these stimulus payments and bailout packages are already several years old, it is only now that the accountability frameworks and auditors are catching up with the haste in which they were delivered.

There were immediate concerns expressed in the United States with people wanting to know where all the money went and some complained that it appeared that most of the funds went to the "*same executives, bankers and stockbrokers who got us into this mess!*"[6].

The crisis has continually highlighted the need for better regulation and supervision of the banking sector. With any increase in regulation, we should expect a corresponding greater demand for enforcement. Rules will be made, rules will be broken.

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[5] Speech by the Honourable Jim Flaherty, Canadian Minister of Finance, Department of Finance Canada, Mar. 26, 2009, http://www.fin.gc.ca/n08/09-036_1-eng.asp [Accessed Sep. 01, 2010].
[6] Robert Scheer, "In for a Penny, In for $2.98 Trillion", Truthdig, Mar. 31, 2009, http://www.truthdig.com/report/item/20090331_in_for_a_penny_in_for_298_trillion/ [Accessed Sep. 01, 2010].

Even before we considered the potential impact associated with new law, regulation and policy, we could foresee an increase in reported financial crime. The collapse of the debt instrument market resulted in considerable losses to investors, both private and institutional. Losses of this magnitude always result in finger-pointing and blaming. In this instance, some contained allegations of negligence while others suggested the behaviour was down-right criminal. We witnessed the collapse of several large Ponzi schemes and one, led by Bernard Madoff was touted as the largest ever and valued at $50 billion dollars[7]. The house of cards inherent of these schemes collapsed when it became difficult to bring in a sufficient number of new investors to cover the ones wishing to dispose of their holdings. As Warren Buffet has said - “When the tide goes out, you can see who is swimming naked”[8]. The economic crisis of the past few years definitely had the effect of revealing Ponzi schemes for what they really were.

Is the Crisis Over?

The end appears to be impossible to predict, and many pessimists see the world economy teetering on the brink of collapse. At first glance, it would appear that not a lot has changed. There should be grave concern that we have not gotten to the root of the problem as the recession has failed to dampen the consumer’s enthusiasm for debt.

In 2009, a survey by the Canadian Payroll Association found that 59% of Canadian workers say they would have trouble making ends meet if their

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[7] Thomas Zambito and Greg B. Smith, “Feds say Bernard Madoff's $50 billion Ponzi scheme was worst ever”, New York Daily News, Dec. 13, 2008, http://www.nydailynews.com/news/ny_crime/2008/12/13/2008-12-13_feds_say_bernard_madoffs_50_billion_ponz.html [Accessed Sep. 01, 2010].

[8] Warren Buffett.(n.d.), BrainyQuote, http://www.brainyquote.com/quotes/quotes/w/warrenbuff383933.html [Accessed Sep. 01, 2010].

paycheque was delayed by even one week.[9] Moreover, in this same survey it was noted that despite the difficult times, 66% of respondents believed that the economy in their town or city would improve and most believed they would receive modest pay increases over the next year. This might suggest that we have reached the point of debt maximization where we are now counting on <u>future</u> pay raises to cover our financial obligations!

Today, retailers in Canada continue to offer extended debt. For example, one store in Canada is currently offering "No money down, 0% interest, no monthly payments for 18 months".[10] There are retailers offering similar deals in the United States and in the United Kingdom[11].

The Canadian Government did take steps to try and reduce high risk debt by tightening mortgage rules. On Oct 15, 2008, Canada implemented restrictions to prevent no-money-down and 40 year mortgages[12]. However, it is noted that some banks are now increasing their promotions of credit cards. In the United States it was recently reported that direct mail credit card solicitations were up 36% in the first quarter of 2010.[13] Furthermore, 8% of U.S. banks say they are easing their lending standards while none say they are tightening. Large domestic banks are easing standards and terms on almost all of the different categories of household loans[14].

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[9] Rachel Sa, "Majority of Canadian employees living paycheque to paycheque, not saving enough for retirement. Younger workers and single parents having most trouble making ends meet", CNW Group, Sep. 14, 2009, http://www.newswire.ca/en/releases/archive/September2009/14/c4808.html [Accessed Sep. 01, 2010].
[10] A. Leon Company's flyer, Aug. 23, 2010.
[11] Bennetts (Retail) Ltd, "Buy Now Pay Later", http://www.bennettsonline.co.uk/buy_now_pay_later.asp [Accessed Sep. 01, 2010].
[12] Canadian Mortgage Trends, "Goodbye to 100% /40-year Mortgages", Oct. 15, 2008, http://www.canadianmortgagetrends.com/canadian_mortgage_trends/2008/10/goodbye-to-10040-year-mortgages.html [Accessed Sep. 01, 2010].
[13] Mintel Comperemedia, Press release, "Insurance, credit cards lead recovery in direct mail", WhatTheyThink?, Jun. 03, 2010 http://whattheythink.com/news/index.cfm?id=44443 [Accessed Sep. 01, 2010].
[14] United States, Federal Reserve Board, "Senior Loan Officer Opinion Survey on Bank Lending Practices", http://www.federalreserve.gov/boarddocs/snloansurvey/ [Accessed Sep. 01, 2010].

In the United Kingdom, just this past week experts were warning that Britain could face a new 'credit card boom' leaving families heavily in debt as they borrow to make ends meet. In fact, despite warnings of a potential double dip recession, banks are presenting customers with offers of even cheaper debt than they made available before the 2007 economic crash[15].

It does not take an economist, nor an accountant to interpret all of this to mean that our economic crisis may be far from over. Within the realm of law enforcement, we are witnessing a demand for corporate fraud investigations of a new level of complexity. This will require specialized expertise and training as we strive to determine if a given scenario was fraudulent, negligent or a lack of due diligence.

Opportunities – Why waste a good crisis?'

Mr. Rahm Emanuel , White House Chief of Staff - "Rule one: Never allow a crisis to go to waste" - "They are opportunities to do big things."[16]

Perhaps it is time is take a fresh look at the definition of Justice as it pertains to white collar crime. What is it we are truly trying to accomplish – market integrity? restorative justice?

Integrated Policing is a concept that is actively promoted in many democratic societies of today. Police chiefs voice strong commitment to all levels of law enforcement working together, and across all borders. However, the level of integration, for the most part, is restricted to partnerships between law enforcement. Yet, when one considers a whole spectrum of enforcement for a given crime type such as financial crime, law enforcement is really only but one

[15] Andrew Hough, "New debt boom fears as banks offer more generous credit card deals", Telegraph, Aug. 23, 2010 , http://www.telegraph.co.uk/finance/personalfinance/7959345/New-debt-boom-fears-as-banks-offer-more-generous-credit-card-deals.html [Accessed Sep. 01, 2010].
[16] Jeff Zeleny, "Obama weighs quick undoing of Bush policy", The New York Times, Nov. 10, 2008, http://www.nytimes.com/2008/11/10/world/americas/10iht-10obama.17675627.html [Accessed Sep. 01, 2010].

actor within a field of players all trying to achieve a common social objective. There are regulators and private sector investigative agencies who share that same common objective. In a Canadian Police College study of this issue, the role of the public police was estimated to account for only 8% of the overall investigative effort.[17]

Herein lies the opportunity. An opportunity to expand the definition of integrated policing for white collar crime to include integration with all partners on the enforcement spectrum. Back up one step, examine the big picture - the overall social objective for white collar crime enforcement, consider who all of the stakeholders are, consider whether they might be valuable as partners and then, invite them to actively participate in a truly integrated strategy. Truly integrated policing begs for integrated partnerships and should not be restricted to only within the traditional law enforcement sector.

It is time to tear down the silos and endorse strong partnerships with the private and regulatory sectors and modify policy and legislation to accommodate such. The victims of these crimes want us all to work together in a cohesive manner - to prevent crimes of this nature from occurring in the first instance, to appropriately punish those persons found committing such crimes and, to recover lost funds on behalf of the victim.

The Canadian Police College implemented a new series of white collar crime training courses this past year in which such a new highly integrated strategy was adopted. One of those courses was dedicated to mortgage fraud. Course participants were challenged to adopt a very high level holistic view of Justice that

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[17] John Sliter, "A Proposal for a White Collar Crime Training Program with an Integrated Service Delivery Model", Canadian Police College, 25 September 2008.

included all potential remedies ranging from civil actions, regulatory sanctions and criminal prosecutions. The class was tasked to use a broad integrated approach to work through problem-based scenarios as a team with three high-level goals of 'Prevention', 'Punishment' and 'Recovery'. Would their chosen course of action prevent the crime from happening again? would their action generate an appropriate level of punishment? and, would their action work towards putting the victim back to a place where they were before the fraudulent transaction took place? The target audience also shifted from just the police to include all investigative agencies working on the enforcement spectrum. There are a number of reasons to consider offering training to the complete spectrum of partners and stakeholders, least of not which is economies of scale. Some others are as follows:

- Enhanced integration results in improved service delivery to the ultimate client - the victim;
- Enhanced integration provides a means of ensuring all stakeholders are familiar with each others mandate; and
- Enhanced integration ensures that all stakeholders become comfortable with the public policy behind enforcement strategy - all working towards a common goal.

Bringing together all of the key stakeholders in an enforcement network for training purposes provides enhanced opportunities for much discussion, planning and coordination of tactical enforcement, and could even lead to the development of enhanced government policy in order to better protect victims. Feedback and analysis to date suggest this type of training is filling a critical need.

In summary, let us hope for strong economic growth that will cause us to forget about the crisis in a few years. But we should get ready for some serious belt tightening as our governments are faced with the daunting task of paying for the stimulus. We should also be prepared for taxpayers demanding that we investigate allegations of stimulus funding gone array and many more complaints from anxious investors who have lost their life savings and watched their equity all disappear. Finally, things may get a lot worse if the tide has not changed and continues to move out. There are many other pressures to consider such as the increased demand put on our social network caused by an aging society, a global food shortage and a western society that has never experienced going without.

As we witnessed in Greece this past year, we now know that this can all lead to rioting in the streets.