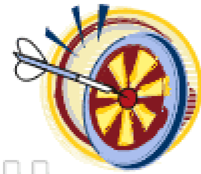
Objectives

after completing this lesson, YOU will be able to



» Discuss the **nature of fraud in financial institutions,** including pension funds, financial services, and insurance;

» Discuss the *Savings and Loan scandal of the 1980s*; and

» Understand that white-collar crime was a material and significant reason for *massive losses in financial institutions during the 1980s.*

For this lesson, please read:

» Rosoff, Pontell and Tillman, *White-collar Crime*:

- **Chapter 8. Fiduciary Fraud**

» Pontell and Shichor, *Contemporary Issues in Crime and Criminal Justice:*

- **Black, "Control Fraud and Control Freaks"**
- **Pontell Rosoff, and Lam, "The Role of Fraud in the Japanese Financial Crisis"**

» Almost everyone knows the story told in the movie *It's a Wonderful Life.* George Bailey (played by Jimmy Stewart) inherits a small savings and loan institution in Bedford Falls. Although George is selfless, honest, and hardworking, he looks on helplessly as the financial institution becomes insolvent through an unfortunate set of circumstances. In despair, George tries to commit suicide, but is saved by a guardian angel. In the end, his institution is returned to solvency by loyal depositors.

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George Bailey was a good man — but he was a fictitious character. The S&L owners of the 1980s, on the other hand, were real people. ***It would be hard to imagine Bailey renamed "George Bailout," which is what the taxpayers did at the end of the S&L fiasco.***

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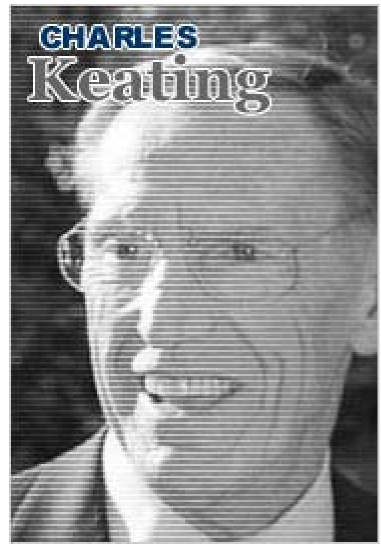
What if George's guardian angel had come from below instead of above? Might he have tried to keep his bank afloat through unlawful investments and fraud? Bribed an auditor? Juggled his books?



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Fortunately for the fictitious Bedford Falls, George Bailey was not Charles Keating, the notorious owner of Lincoln Savings and Loan of Irvine, California, or Don Dixon, of Vernon Savings and Loan in Dallas, Texas. Nor was he like the thousands of others involved in what was at the time the largest financial scandal in American history: ***the Savings and Loan Crisis.***

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Fiduciary fraud is a major area of ***white-collar crime***. As this lesson illustrates, significant crimes have occurred in the banking, insurance, and pension fund industries — all of which handle **"other people's money."**

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We'll look at the S&L crisis in depth in Topic 4. First, however, we'll consider fraud in other financial institutions: pension funds, financial services, and insurance.

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It has been said by some more enlightened experts that we tend to regulate in the reverse order of risk when it comes to corporations and financial institutions. *Employee pilferage and embezzlement by lower-level employees are serious problems that need to be controlled, but the greater loss risks occur at higher levels. CEOs and directors can loot their organizations of much more money much more quickly, and they have done this time and again. Yet, up until recently, they have tended to be regulated the least.*

- One major category that has seen its share of major losses is the ***pension fund*** industry. The looting of funds from retirees and workers can be seen as one of the more callous forms of **white-collar crime**. Such funds are loosely regulated, and the results can be devastating for those who entrust them with their money.

- The case of First Pension in California represents one of the largest swindles in the pension fund industry. **The company was seen as so solid that judges and lawyers recommended it to those who received windfall settlements as a place to invest their newfound wealth**. First Pension in California, however, was nothing but a gigantic Ponzi. Its owner, William E. Cooper, engaged in a number of schemes to keep regulators and even his own employees at bay.

* Another area of major fraud is in the investment and financial services sector. One of the largest cases of ***white-collar crime*** occurred in the investment firm Institutional Treasury Management, which was headed by Steven Wymer. Again, this was nothing but a giant Ponzi.

* Wymer was able to cover up the scheme through **arrangements with broker-dealers who did not send monthly financial statements to customers** — mostly municipalities and government agencies that had invested taxpayer funds with him.

* *Ironically, it is when such governments and agencies are squeezed the most by shrinking budgets that they seek investments with higher returns in order to make ends meet. Such higher returns are also subject to higher risks, or are simply fictitious and part of a fraudulent Ponzi scheme.*

No one "likes" to pay taxes, but by not paying enough, it seems that we become more vulnerable to losing them altogether, as officials scramble to make up the difference.

» *Insurance*

Insurance company frauds are yet another form of fiduciary crime. Insurance is one of the most pervasive and lucrative businesses in America. ***Companies sell over $400 billion in insurance policies every year***. Larger companies are generally law-abiding and reputable, but there are numerous smaller companies that can cause major damage to the entire industry.

Again, extremely weak regulation can be cited here in an industry with more than 5,000 companies, and more than $2 trillion in assets.

Several forms of fraud are seen in the insurance industry:

- ***Premium diversion:*** Funds collected to cover claims are used for other purposes;
- ***Creating phony assets:*** Phony assets are created to meet capitalization requirements necessary for companies to pay claims and write new business;
- ***Use of the Multiple Employer Welfare Arrangement (MEWA):*** Even less regulated than conventional insurance companies, this allows smaller companies to enter into insurance arrangements together in order to receive lower premiums, as **"money machines"** for the companies that administer them; and
- ***Excessive reinsurance:*** Companies sell off policies (liabilities) to unregulated offshore companies (many of which are simply shell companies or fronts that never pay a single dime to original policyholders when a claim is filed) in order to write more policies and increase profits.

Offshore insurance scams have also surfaced, with swindlers actually getting away with registering their fraudulent companies in make-believe nations — **complete with phony passports and bogus currency!**

» *The "Fantasy Islands" case study documents such "cyber-countries" and "virtual nations." **Just as astonishing, perhaps, is the slow official response to such incredible fraud.***

Up until the recent corporate meltdowns, the S&L debacle of the 1980s stood as the costliest set of **white-collar crimes** in American history.

Its total cost to American taxpayers was approximately $200 billion.

» For all the good and bad things associated with the Clinton administration, one solid decision was made: **to use the government surplus generated during those years to pay off the cost of the debacle in full, and leave the country on a much better financial footing.** Had that decision not been made, the eventual cost (with added interest over the years) could easily have approached a half-trillion dollars or more.

* ***The S&L debacle has been well-documented in a number of government reports, including findings from a national commission, and academic articles and books.***

The major study of **white-collar crime** and government response in the savings and loan crisis was funded by a grant from the Department of Justice and conducted by Henry Pontell, Kitty Calavita, and Robert Tillman. The researchers provided written and oral testimony to Congress, a final report to the DOJ, and published a number of articles and chapters, as well as the award-winning book **Big Money Crime**: ***Fraud and Politics in the Savings and Loan Crisis.***

Much of the information collected during the crisis, which could be termed ***"the accepted economic wisdom,"*** *provides the official explanations for the debacle.* ***Contrary to this, the researchers provide empirical, historical, and theoretical evidence that shows that white-collar crime was a material and significant reason for massive losses in financial institutions during the 1980s.***

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Moreover their findings point to a new form of fraud — ***collective embezzlement*** *— which is committed by controlling insiders. It is part of a more general category of such crimes known as control fraud.*

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» The origins of the S&L disaster have been well documented in the literature. ***Thrifts were experiencing massive losses in the 1970s as stagflation (a combination of high interest rates with slow economic growth) squeezed financial institutions at both ends***. To attract new funds, institutions had to offer higher interest rates on deposits than they were receiving from long term home loans, which created a negative rate spread.

» Moreover, thrifts now had to compete with newly created money-market mutual funds on Wall Street that allowed ordinary investors to buy shares that paid high money market rates that precipitated disintermediation, or massive withdrawals from savings and loans. ***The industry's net worth fell from $16.7 billion in 1972 to a negative net worth of $17.5 billion in 1980.***

Major deregulatory measures enacted during the Reagan administration designed to restore thrifts to a solid financial footing actually made the situation worse, as losses continued to escalate. **New powers given to financial institutions allowed them more freedom to make loans, charge higher interest rates, and allow larger government insured accounts, all of which were intended to create greater profits.**

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> *Unfortunately, the effect of such deregulation (or, as some have called it, "unregulation") was to attract crooks and hustlers to an already troubled industry. Instead of "saving" the savings and loan industry, these opportunistic entrepreneurs saw the chance to plunder it. Under deregulation, thrifts became money machines for the unscrupulous, and most of the industry was driven into insolvency.*
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When the feeding frenzy ended in the late 1980s, government regulators had to act as undertakers. They cleaned up the remains of the industry by reimbursing depositors whose funds had been lost and stolen, and attempted to sell off any remaining assets of failed thrifts for whatever price they could get.

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Researchers identified three basic categories of **white-collar crime** in the S&L debacle:

- *desperation dealing, or unlawful risk-taking*
- *collective embezzlement*
- *covering up*

* **Desperation dealing** included a number of unsafe lending practices that violated the law. These gambles usually never paid off, and they involved huge losses that drove many institutions into insolvency.

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While some argued that these investments were simply desperate attempts on the part of insiders to save their failing institutions, the evidence points more directly to fraud. **Unlike traditional corporate crimes in the industrial sector, these financial crimes usually contributed further to the bankruptcy of the institution.**

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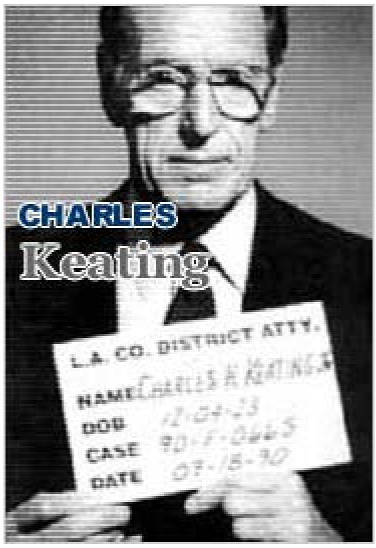

» Collective embezzlement refers to premeditated gain on the part of thrift owners who systematically siphoned off funds from their institutions for their own personal gain. Unlike traditional forms of embezzlement committed by lower-level employees, collective embezzlement involved owners, managers, and others both inside and outside the organization itself.

» Collective embezzlement was found to be the most costly form of thrift fraud during the S&L crisis. One high-ranking official sums up most of the wrongdoing during the thrift debacle in these words: **"The best way to rob a bank is to own one."**

Covering up was probably the most pervasive form of thrift fraud. It included numerous schemes to hide both the institution's insolvency and the fraud that contributed to it.

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*Such crimes usually involved a manipulation of **S&L** books and records. File stuffing (putting lending documents into a file after the loan had been made), and false paperwork that attempted to hide fraudulent transactions, were common forms of covering up.*

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These forms of fraud involved insiders, accountants, and lawyers. ***But appraisers and developers were also involved in thrift crimes.***

Such outsiders were involved in criminal networks that took advantage of lax regulation of financial institutions. Their schemes included:

» ***Land flips:*** Selling pieces of property among institutions, and each time pumping up the price to take hefty profits from fees and points on each transaction.

» ***Nominee loans:*** Using "straw borrowers" who were indirectly connected with the thrift to avoid regulations regarding loans to insiders.

» ***Reciprocal lending:*** Loans between institutions, again designed to avoid regulations on insider loans.

» ***Linked financing:*** Placing large amounts of deposits within an institution on the condition that loans would be made that were never intended to be paid back.

The S&L crisis brings into focus the devastating nature of widespread financial frauds. A major industry, insured by the government, and the entire US economy were brought to the brink of disaster.

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Taxpayers bailed out the industry. Thrifts were re-regulated in 1989 through major federal legislation (FIREAA), which restructured federal agencies and plugged the legal loopholes that had provided a criminogenic industry environment that facilitated numerous forms of ***white-collar crime.***

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Forum *discussion*

"to post your reply, select OUTLINE from the TOOLS menu and enter the FORUMS area"

Using the case study of Charles Keating, what aspects of his case do you feel best illustrate the problems presented by ***white-collar crime?***

Summary

a brief overview of what you learned

» **Fiduciary fraud is a major area of white-collar crime**. Significant crimes have occurred in the banking, insurance, and pension fund industries.

» **Fraud in the investment and financial services sector tends to affect municipalities and government agencies that invest taxpayer funds**. When governments and agencies seek investments with higher returns in order to make ends meet, they run the risk of investing in a fraudulent Ponzi scheme.

» Insurance industry frauds include premium diversion, creating phony assets, use of the Multiple Employer Welfare Arrangement, and excessive reinsurance. Offshore insurance scams have also surfaced.

» Researchers identified three basic categories of white-collar crime in the S&L debacle: **desperation dealing, collective embezzlement, and covering up.** These forms of fraud involved insiders, accountants, and lawyers. But appraisers, and developers were also involved in thrift crimes.

» **The S&L crisis brings into focus the devastating nature of widespread financial frauds**. A major industry, insured by the government, and the entire US economy was brought to the brink of disaster.