CHAPTER 1

The Fraud Culture

American organizations lose approximately 7 percent of gross revenue to fraud *every year*, according to the Association of Certified Fraud Examiners (ACFE).[1]

In 2006 (the last year for which data are available), of 21 industries studied by the ACFE, banking/financial services topped the list in terms of number of internal fraud incidents reported. A fairly distant second was the government and public administration, followed by healthcare.[2]

What does this tell us about fraud in the financial services industry? Other than the obvious fact that 7 percent of gross revenue of *any* bank or financial services firm represents a large sum of money, the industry's dubious distinction as having the most incidents of internal fraud speaks to the disturbing reality that fraudulent behavior has become integral to the culture of this sector.

The reasons for this are complex but it is hoped that understanding them will help political, industry, and social leaders come up with new laws and regulations to control the fraud problem in financial services.

As for professionals whose duties *include* fraud detection and prevention, understanding the mentality of this "fraud culture" is *essential* to developing deterrents, incentives, regulations, laws, and any other potential weapons for effectively stopping the growth of this cancer.

Without knowing how and why the basic values and ethics of large swathes of the financial industry became egregiously compromised, there is little chance of restoring the integrity, fairness, and respect for others that—reassuringly—represent the ethical guidelines by which many financial executives and professionals still conduct their affairs.

I Wanna Be Rich

As the "Land of Opportunity," America has for over 200 years provided better odds of success than any economic system in history to individuals seeking to become materially wealthy. It is thus not surprising that America has always been the country with the largest number of ultra-wealthy individuals. In *Forbes* magazine's latest tally, 11 of the world's 25 richest people reside in the United States.

This is surely not a bad thing. Together with constitutionally guaranteed political, economic, and civil freedoms and a unique cultural spirit of optimism, ingenuity, and excellence, this "golden promise" has made America the most successful free market nation in history.

Similarly, the successes of America's first generation of true business icons like Morgan, Carnegie, and Rockefeller, and most recently, Gates, Buffett, Jobs, and Trump, have reinforced the inspiration of millions who choose to devote themselves to the pursuit of financial happiness.

Historically, for most entrepreneurs, getting rich has been a *healthy* obsession—one that has pushed them to strive for perfection, work as hard as it takes, and commit to never giving up despite the risks. Many possessing these personality traits have built successful businesses that collectively employ millions, generate billions in tax revenue, and comprise the 20 million-plus small businesses responsible for the lion's share of U.S. economic growth.

But the American promise of limitless wealth has long been tainted by a subculture of individuals possessed of the misconception that becoming wealthy is easy. These folks subscribe to the false notion that getting rich—preferably quickly—is a fundamental entitlement of every American citizen. What they fail to realize is that the entitlement bestowed by the Constitution is simply to *pursue* wealth—*not* to have it hand-delivered by the U.S. Department of Getting-Rich-Quick.

Many thus learn the hard way that getting rich—to put it bluntly—ain't easy. Many give up when they run up against this disheartening reality. Most find contentment in alternative pursuits and non-material achievements, such as raising a family, pursuing hobbies, involving themselves in community volunteer activities, and so on.

However, a small but by no means insignificant contingent of wealth-seekers *don't* give up, despite a lack of resourcefulness, reluctance to invest personal capital, and, most important of all, the absence of sufficient drive to put in the long hours and weather the inevitable stresses to get a successful wealth-generating enterprise off the ground.

These are the individuals who resort to cutting ethical and legal corners to achieve their financial goals. They are the ones whose collective misconduct results in the estimated $1 trillion in fraud losses sustained by U.S. organizations collectively *every year*.

It is to understanding the psychology, motives, and mentalities of these wrongdoers whose financial misconduct costs corporate America so dearly and has frayed the fabric of American social values since the 1970s, that this book is dedicated.

The Spread of Ethical Erosion

Since the early 1930s manifestations of what has been referred to as "white-collar crime" have been evident at varying levels of severity. Offenders range from the one-time embezzler who takes just enough from his or her employer to get through an isolated bad patch, to the criminally compulsive captains of industry who looted their companies or drove them to financial ruin. Also included are crimes by those whose professional status encompasses ranks superior to those of hourly laborers, which have all been amply chronicled.

Every one of them has had his or her own reasons for doing what they did. And every one of them has rationalized in one way or another their criminal conduct.

It is the uninterrupted spread of this culture of "justifiable corner cutting" that explains much of why the financial markets were driven to the brink of disaster in 2007 and 2008. It was an unbridled money grab which originated in the late 1970s when names like Michael Milken and Ivan Boesky jumped on to the front pages of American newspapers and gripped the nation from Wall Street to Main Street. The trend played out through a perfect storm of deadly forces including:

- The Wild West–like hawking by ethically-challenged brokers of too-good-to-be-true mortgages to borrowers who either were talked into believing—or truly did believe—that they could make payments that they clearly could not.
- An unprecedented nationwide spending spree financed by consumer credit whose issuers clogged mailboxes with little plastic rectangles dressed up as licenses to shop until you drop, but with so many hidden financial tripwires that the rate of default on credit cards inevitably rose to all-time highs.

- Wall Street's headlong foray into new high-risk securities called derivatives, so complex that even supposedly sophisticated Ivy League mathematicians could hardly comprehend them, but which the industry's army of marketing mavens managed to persuade pension funds, multinational corporations, global banks, and self-described investment geniuses to purchase by the billions.
- The explosion of mind-boggling technological "tools" mushrooming from the global envelopment of the Internet into cellular telecommunications, powerful financial and investment software, wireless computing connectivity, and high-volume electronic data management. All were developed by techno-wizards with laudable intentions, but were promptly adapted by what came to be known as the "black hat" community of high-tech fraudsters, saboteurs, and terrorists.
- A full-blown epidemic of cyber-driven identity theft and fraud that sandbagged the financial lives of tens of millions of Americans. Information security breaches such as those that victimized retail giant TJX, credit card processor Heartland, and even Microsoft and JP Morgan Chase resulted in billions in banking and retail losses and compromised the belief system of a nation of trusting consumers by eroding their faith in the banking system and raised their suspicions about on-line commerce, Internet banking, and other twenty-first century technological advances that could have, and *should* have, bolstered America's global competitiveness and economic well-being.

The product of these forces was a palpable erosion of America's value system of community, charity, and benevolence in favor of an "every-man-for-himself" mindset that has directly or indirectly fueled a boom in fraud of all kinds. The following statistics, after all, are not arbitrary. They reflect the confluence of the forces discussed above, as well as other factors that researchers have yet to understand:

- The 7 percent of gross revenue lost to internal fraud mentioned earlier currently represents nearly $1 trillion in fraud losses, not counting the additional billions lost to external fraud such as cyber-attacks, organized crime syndicates, and the exploits of dishonest vendors, ex-employees, and customers.[3]
- The Federal Trade Commission (FTC) reported that in 2008, 643,195 Americans filed complaints of having been victimized by fraudsters. That number represented a startling increase of nearly 50 percent from 428,394 in 2006.[4]
- The U.S. financial services industry experienced the largest number of internal fraud incidents of the 21 industries studied by the ACFE.
- The number of victims of identity theft skyrocketed between 2000 and 2009 from 31,100 to 1.2 million.[5]

What It All Means

Fraud and corruption have always been components of American culture. The Mob, Tammany Hall, Prohibition-related political graft, union corruption, securities fraud in the pre-Depression era, the Savings and Loan (S&L) fraud fiasco of the 1980s, corporate scandals like Enron, Tyco, WorldCom, and HealthSouth in the 1990s and 2000s, and now the subprime mortgage meltdown and related securities frauds like those that brought down Bear Stearns collectively portray an American cultural landscape with criminal blemishes aplenty.

However, as statistics and the personal experiences of many Americans over the age of 45 confirm, fraud, corruption, and ethical misconduct was *not* as prevalent in the 1970s and early 1980s as it is now.

Indeed the occasional corrupt city official, local judge, or state representative made headlines from time to time in earlier times. And of course the Mob's grip on the gaming industry made it a hotbed of financial skullduggery starting in the 1930s.

But the fraud-driven destruction of a $100 billion company like Enron? The theft of $65 billion through a one-man Ponzi scheme? The demise of a Wall Street icon like Bear Stearns at the hands of two rogue hedge fund managers? Such earth-shattering incidents were practically unheard of until the late 1980s.

Why? The late 1970s and early 1980s marked the early stages of what would become the perfect storm of the 2000s. It was the period of unmitigated financial abuse by a contingent of moral misfits who abused deregulation of the S&L industry to steal $150 billion of depositor and investor funds.

It was the period of Michael Milken whose junk bond exploits and insider trading crimes shook Wall Street and made him Public Enemy Number One in the financial world.

And it was the period of corporate raiding, dismantling, dissolving, and divesting. Not illegal or particularly unethical per se. But fuel for the demise of Wall Street decorum and collegiality and the ascent of personal avarice that some would say culminated in the financial crisis of 2007–2008, by which time long-standing written and unwritten rules of fair play among financial institutions had been discarded as so much ticker tape.

John Bogle, the revered founder and long-time CEO of the Vanguard Group of Mutual Funds, explains the change this way: "Unchecked market forces overwhelmed traditional standards of professional conduct, developed over centuries."

"The result is a shift from moral absolutism to moral relativism. We've moved from a society in which 'there are some things that one simply does not do' to one in which 'if everyone else is doing it, I can too.' Business ethics and professional standards were lost in the shuffle."[6]

Irony played no small role in this 30-plus-year saga. The baby boomers who made the Woodstock period a historical milestone in the same category as Lincoln's emancipation of the slaves and Kennedy's triumph in the Cuban Missile Crisis, were the generation of *anti-materialism*. They worshipped Vonnegut and Brecht and disdained two-car garages. They embraced diversity and selflessness and vilified the military industrial complex.

And where did they end up when they walked into the real world with their Ivy League diplomas and their promise to help build a "pseudo-socialistic, back-to-the-land" America?

Though Bill Clinton never inhaled, it is without doubt that many of his less self-disciplined contemporaries who did ultimately cut their hair, shed their bell-bottoms and landed on Wall Street, in the prestigious litigation departments of white-shoe Manhattan law firms and in the trenches of America's preeminent financial institutions that led the Western world to a new post-war period of unparalleled abundance, prosperity, and the promise of limitless fast-action material potential.

As John Talbott, a former Goldman Sachs investment-banker-turned-author wrote in one of his illuminating books, one of the driving forces of the 1990s housing boom was a "constant drive for status. Seeking status is a strong genetic urge. . . . It is hard to see the rationality of an American couple with fully grown children who had left home wanting to live in 12,000 square foot monster homes or own four and five cars. If not for status, that is."[7]

This mad dash for material excess was symptomatic of the money-grabbing culture mentioned above. It was intimately intertwined with the rationalizations by financial and corporate titans when they could not (or chose not to) resist the temptations to bend the rules, exploit regulatory loopholes, and commit the massive frauds that contributed to the explosive growth of white-collar crime in the 1990s and 2000s.

How We Got Here

It was of course the perplexingly intricate tapestry of stock markets, bond markets, derivatives markets, and virtual markets that became the feeding ground for technologically-driven money grabbers that took center stage in the "evolution" of American values in the latter decades of the twentieth century and into the first decade of the twenty-first.

In illustrating this multifaceted transfiguration, David Callahan, author of *The Cheating Culture*, points to the case of Scott Sullivan, the former CFO of WorldCom and right-hand man to the ill-fated company's CEO, Bernard Ebbers. Callahan notes that for a decade of his tenure at WorldCom, Sullivan lived with his wife in a modest home in South Florida that they bought in 1990 for $170,000. But between 1990 and 2000, when Sullivan's stake in WorldCom had peaked at more than $150 million, something profound changed in the CFO's psyche. "He [Sullivan] could have cashed out as an immensely wealthy man," writes Callahan. "He chose to stay on. And, over the next two years, WorldCom cooked its books with astonishing brazenness while Sullivan was CFO, the corporate official most directly responsible for the veracity of the company's numbers. WorldCom inflated its earnings by some $11 billion through a variety of financial manipulations. When the true accounting was completed by investigators, they alleged that Sullivan had directed the largest corporate fraud in history."

What caused this drastic abandonment of ethics and the embracing of a mindset which clearly lacked any moral compass whatsoever? As Callahan postulates, perhaps Sullivan viewed himself as a corporate hero, doing whatever was needed to preserve thousands of jobs. On the other hand, Callahan rightly points out that Sullivan had personal motives to fudge the numbers because his pay package was directly tied to the company's stock price.

Neither of these explanations, even if they actually co-existed, can possibly explain why a "normal" financial professional would turn so abruptly and unequivocally to financial crime. And herein lies the critical lesson of the Scott Sullivan tragedy (Sullivan spent five years in jail and lost all of his financial assets). Writes Callahan:

> *I believe that the best explanations of why we have more Scott Sullivans and Barry Bondses . . . boil down to changes in the economy and the new rules that govern it. Our winner-take-all system dangles immense rewards in front of people, bigger than ever before. And today's business culture demands, and glorifies, extreme levels of competitiveness. Meanwhile, the Winning Class has worked to emasculate government regulators . . . reshaping the rules so that it can get away with economic murder. . . . To understand the ethics of Scott Sullivan and his ilk, you have to understand how the values of American society have changed. . . . We have a nastier, more cutthroat set of values than previous generations did. As the race for money and status has intensified, it has become more acceptable for individuals to act opportunistically and dishonestly to get ahead. Notions of integrity have weakened. More of us are willing to make the wrong choices, at least when it comes to money and career.*[8]

The Evolving Shapes of Fraud

While evidence of Callahan's sobering cultural portrait abounds in our everyday lives—just turn on your local TV news anytime of the day or night—it begs the question: *How did we get this way?* To answer that, we must first understand *who* commits fraud.

There is some disparity in the findings of several research studies on how much of total fraud is committed by insiders compared with external perpetrators. Some data put the ratio at 60–40[9]; others come in closer to 80–20. In any case, most research shows that on average, the majority of fraud committed against *all* U.S. organizations is internal.

Who Are the Bad Guys?

Nonetheless, when it comes to external fraudsters, organizations have a dizzying array of perpetrators to worry about.

Most serious, in terms of the dollars involved (though not necessarily dollars *lost*), are money launderers. This group includes the far-flung global population of drug-traffickers, as well as members of organized crime, illegal gambling operators, and others.

Although financial institutions are directly responsible for monitoring and reporting money laundering activity, because they are typically not *parties* to such activity, they are not always *victims* of these crimes. Moreover, money laundering, while ranked by researchers as one of the largest "industries" in the world in terms of dollars transacted, has been around for centuries and as such does not require special analysis in the context of the financial crisis.

However, there are plenty of external fraudsters besides money launderers who cause massive losses to organizations of all kinds—and who thereby contribute to the cheating culture that David Callahan so accurately describes. Among these folks are:

- Dishonest customers (retail *and* commercial)
- Identity thieves/fraudsters
- Check forgers and counterfeiters
- Dishonest vendors

- Ex-employees
- Internet fraudsters (including phishing attackers, hackers, malicious code programmers)
- Credit card fraudsters
- Crooked mortgage brokers, lenders, appraisers, and attorneys.

Unfortunately, because external fraudsters are so varied in terms of the business, social, and geographical environments in which they operate, it is extremely difficult to identify common personal, behavioral, or demographic characteristics. They can be:

- Hardened career criminals
- Occasional opportunists
- People who target organizations for the "thrill of it"
- Individuals who do what they do out of desperation (which is increasingly the case during economic downturns, when, for example, banks regularly experience spikes in credit card fraud, identity-related frauds, and Internet crime)

The bottom line is that there are few if any behavioral or demographic characteristics common to all external fraudsters. However, we can safely say that their numbers are increasing, the financial damage they cause is growing, and the cultural degradation they perpetuate is definitive. Further detail on these outsider miscreants will be provided in Chapter 4.

The Insider Threat

Fortunately for fraud-fighters, *employees* who commit fraud do have common personality and behavioral traits. They are also prone to scientifically-proven psychological influences that help fraud prevention experts to identify them.

In general, research on internal fraud shows that about 80 percent of employees in any financial services institution are fundamentally honest.

If that is the case, you may wonder, how can internal fraud be such a costly threat to business, society, and American culture? Many fraud prevention experts use the so-called "20-60-20" rule to illustrate the human component of internal fraud:

- 20 percent of the people in any organization will never steal—no matter what. They are individuals whose character and integrity are so unwavering that nothing could pressure or tempt them to do anything dishonest.
- 60 percent of the people in the organization are "fence sitters." They are basically honest people. But, if given the *opportunity* to commit fraud and the risk is perceived to be minimal, they might cross the line.
- The remaining 20 percent are inherently dishonest. They will always commit fraud when the opportunity arises. In fact they will often *create* opportunities to steal or deceive if they think it will result in personal financial gain.[10]

To understand the insider fraud threat it is helpful to divide it into two key categories:

1. *Employee-level fraud.* This type of fraud is committed by people who are neither supervisors nor managers or executives. They may be salaried professionals or hourly employees.
2. *Management-level fraud.* These crimes are committed by managers at all levels—including the most senior levels. Many of the frauds committed by these individuals are the same as those committed by employees lower down the organization chart.

   Though committed with less frequency than employee-level fraud, virtually *all* management level frauds result in much greater losses than those perpetrated at lower levels.

> This fact is underscored every time we hear about another senior executive being arrested, indicted, or convicted of a serious financial crime such as cooking the company's books, looting the business, or paying bribes.

The reason is clear: Managers have more authority and therefore more opportunity to cheat than those who work under them.

The Fraud Triangle

One set of factors common to internal fraudsters *at all levels in any organization* is the Fraud Triangle. The theory behind the Fraud Triangle was developed in the 1940s by a leading criminologist, Donald Cressey who conducted extensive research with convicted embezzlers to determine what motivated seemingly honest people to commit fraud.

His research led him to the conclusion that people who are experiencing severe financial problems about which they are embarrassed (or for other reasons cannot discuss with others), find ways to commit fraud—thinking that they won't get caught while convincing themselves that they are doing nothing wrong.

Eventually, Cressey's findings came to be summed up in what is now widely referred to in the antifraud profession as the "Fraud Triangle." Its three components—just as Cressey suggests in more complex wording—Pressure, Opportunity, and Rationalization (see Exhibit 1.1).

1. *Pressure* in the context of Cressey's Fraud Triangle relates specifically to financial difficulties such as large amounts of credit card debt, an overwhelming burden of unpaid healthcare bills, large gambling debts, extended unemployment, or similar financial difficulties.

EXHIBIT 1.1 **Fraud Triangle**

In the context of the financial crisis, such pressure manifested itself in cutthroat competitiveness and intensifying urgency to generate larger and larger profits.

2. *Opportunity* exists when an employee discovers a weakness in the organization's antifraud controls. Such a weakness might exist, for example, if an employee is able to set up a phony vendor and have fraudulent invoices paid and mailed to an address that he or she controls or if poor controls enable a senior bank executive to approve mortgages or other loans he knows to be fraudulent.
3. *Rationalization* is a psychological process whereby a person who has committed fraud convinces himself that the act is either not wrong, or that even though it *may* be wrong, it will be "corrected" because he will eventually return the money. At a much riskier level, such as that which prevailed in financial markets in the years leading up to the financial crisis, rationalization can involve self-justification of acts that may prove either calamitous, illegal, or both because the potential payoff is too great to ignore.

In essence, Cressey's theory teaches that when all three of these elements are in place in an individual's life, he or she is very likely to commit fraud (or already has). However, criminal justice experts and psychologists who have conducted research since the publication of Cressey's work argue persuasively that all three elements do *not* have to be in place for an individual to be driven to commit fraud. Indeed, there are numerous cases suggesting that financial pressure alone is enough to push an individual to *seek* an opportunity to steal and that rationalization played little if any role in premeditation of the crime.

Pressure, Opportunity, and Rationalization on Wall Street

Pressure

It is important to note that the Fraud Triangle's element of *pressure* can take many forms at both the executive and employee levels of financial institutions.

For example, exorbitant executive compensation packages took center stage in the debate over whether and how much federal bailout money should be handed out to the likes of Merrill Lynch, Citigroup, American International Group (AIG), and JPMorgan Chase. Many analysts, politicians, and pundits argued that the pressure on these executives to boost their companies' financial performance in order to "earn" bigger bonuses caused them to cut legal and ethical corners.

Though this issue is complex, there is little dispute that the resulting "culture" of short-term earnings performance that swept not only through the financial services industry but through American businesses in general in the 1990s and early 2000s did induce many top executives to cook the books in order to fatten their bonuses, or in some cases, to preserve their jobs.

To succeed, these bosses sought—and all too often found—*opportunities* to break the rules governing accounting and security matters in order to obtain the performance goals they felt pressured to attain.

Pressure at Lehman Brothers: An Extreme Example

In the wake of the implosion of the 160-year-old investment firm he had run for 15 years, Lehman Brothers' last CEO, Richard Fuld told Congress that he never regretted any of the decisions he had made in his final months at Lehman.

Fuld, who has been characterized by numerous Wall Street experts as ferociously competitive and dead-set on victory in every business challenge he takes on, proved to have exercised excessive hubris during the heyday of the subprime mortgage frenzy.

"He exuded hostility," said New York author and critic, Ken Auletta in an interview with ABC News.[11]

That quality apparently served him well over the 40 years he was employed by Lehman. But in his final years as CEO, Lehman amassed a reported $650 billion in assets, of which much was represented by risky subprime mortgage-backed securities, with only 3 percent in shareholder equity. This earned Fuld widespread criticism for having made over-the-top bets with far too much borrowed money.

No doubt, had Fuld read the tea leaves accurately and continued to grow the firm's profits as he had done by astounding leaps during his 15 years at the helm, he would have been the hero of Wall Street that he no doubt dreamed of becoming.

Lesson learned: Pressure, be it self-imposed or a product of the financial services "culture," drove some of the best and the brightest of Wall Street to take risks that would have been unheard of a short 10 years earlier. Their actions poured tankloads of fuel on the financial wildfire that threw the entire global financial system into a state of unprecedented panic and distress.

As illustrated in detail in Chapter 7, Richard Fuld was the archetypical tragic figure in this calamity.

Importantly, the Lehman Brothers implosion is not the only indicator of how the ego-driven, winner-take-all mentality that consumed Wall Street played a decisive role in hastening the onset of the financial crisis. Another high profile example is what took place with AIG. The insurance giant's problems began when four former executives of Berkshire Hathaway subsidiary, General Re, and one from former General Re client, AIG, were convicted on charges related to fraudulent financial transactions between the two insurance giants. In early 2008, a federal jury found them guilty on all 16 counts in their indictment, including conspiracy, securities fraud, mail fraud, and making false statements.

Specifically, prosecutors had accused the executives of inflating AIG's reserves by $500 million in 2000 and 2001 through fraudulent reinsurance deals that made AIG—General Re's largest client—look stronger than it was, thereby artificially boosting its stock price.

At the trial, former AIG Chief Executive Maurice R. ("Hank") Greenberg, who led the company for nearly four decades and is credited with most of its growth, and General Re's then chief executive, Joseph Brandon, were identified as unindicted co-conspirators.

The General Re frauds were perpetrated because the five executives felt pressure to embellish AIG's financials. The result was stiff prison sentences for the offenders. That Greenberg escaped conviction and punishment is a testament to his immense influence on Wall Street and in political circles. As an executive, however, he is no angel, according to numerous people who have had dealings with him, including one former senior executive who worked closely with him for many years. According to this person, who insisted on anonymity, Greenberg ran AIG with an iron fist and intimidated many a subordinate without restraint.

For his part, though, the pressure that Greenberg felt during this time was driven by his enormous ego. His primary mission in life, the former executive explained, was to ensure that AIG remained the largest insurance company in the world—*not* to amass more money for himself.

The key lesson within the context of the ominous attitudinal changes that took place in boardrooms in the 1990s and 2000s is that the Fuld and Greenberg examples are representative of an all too common ego-driven psychology of the ends justifying the means. It is not dissimilar from the mentality that pushed numerous other executives, including WorldCom's Bernard Ebbers, Adelphia's Rigas family, Tyco's Dennis Kozlowski and former Countrywide CEO, Angelo Mozilo, to be investigated and charged with serious financial crimes.

Opportunity

The internal controls *and regulatory oversight* that might have prevented many of the high-profile frauds of the 1990s were clearly absent. The well-documented string of financial reporting frauds beginning with Enron prompted Congress to ultimately pass the Sarbanes-Oxley Act (SOX) in 2002. Unfortunately, the events of subsequent years indicate that SOX has fallen short of its intended goal of eliminating many of the opportunities in large corporations to commit financial fraud.

In the securities world, for example, such opportunities often exist when employees are able to trade without adequate supervision or controls and can execute transactions for their own benefit. While, as mentioned earlier, this is not an uncommon occurrence, this trap was dramatically spotlighted in early 2008 when "rogue" trader, Jerome Kerviel of Société Générale was found to have lost the bank $7 billion by taking a number of large, unauthorized, but highly risky trading positions.

At middle management levels, poor controls or lack of oversight can enable dishonest insiders to:

- Falsify loan applications and other financial documents
- Authorize and/or approve phony appraisals of property for which financing is sought
- Collude with dishonest mortgage brokers

However, the "big-time," headline-grabbing financial institution frauds are those committed by top executives. In the context of *opportunity*, these crimes typically involve falsifying financial statements and records—in response to the pressure discussed above.

Opportunities to commit these potentially costly financial crimes exist when there is a lack of board oversight, weak internal controls over financial reporting, or when transactions of dubious legality are so complex that they cannot be readily understood let alone stopped before being carried out.

Rationalization

With regard to rationalization, the most common psychological justification for committing fraud at the top levels of financial services companies is, in crude terms, "whatever it takes."

Richard Girgenti, National Leader for KPMG's Forensic Practice used this exact term to describe the mindset that in recent years has overtaken U.S. businesses as a result of misguided performance reward systems. He added that "Restoring trust and confidence in the integrity of our capital markets and institutions will require business leaders to build corporate cultures that reward 'doing the right thing,' "[12] implying that the ethical culture of U.S. businesses has been strongly compromised by the pressures that "give rise to fraud risks."[13]

Although there is no scientific or academic research to explain the rise of the *rationalizing* attitude of "whatever it takes," the timeline appears consistent with the steady fragmentation of the financial services industry.

Recent history bears out Girgenti's assessment. Whereas Wall Street firms and banks throughout America (excluding perhaps S&Ls) had acquired an image of integrity, financial conservatism, stability, and unshakeable profitability in the early decades of the post–World War II era, this all came apart once the steamroller of acquisitions, mergers, and divestitures that populated the business news headlines shifted into high gear in the late 1980s, 1990s, and early 2000s.

The list of such acquisitions, mergers, and divestitures is lengthy. A helpful snapshot comprises the following milestones:

- Lehman sold itself in 1984 to Shearson, an American Express-backed electronic transaction company. Later the same year, the combined firms became Shearson Lehman/American Express.
- In 1988, Shearson Lehman/American Express and E.F. Hutton & Co. merged as Shearson Lehman Hutton Inc.
- In 1993, under newly appointed CEO, Harvey Golub, American Express began to divest itself of its banking and brokerage operations. It sold its retail brokerage and asset management operations to Primerica and in 1994 it spun off Lehman Brothers Kuhn Loeb in an initial public offering, as Lehman Brothers Holdings, Inc.
- Citicorp merged with Travelers Insurance in 1998. (The previous year, Travelers had absorbed Salomon Smith Barney). In 2001, Citi bought European-American Bank.

- In 2002, Citi acquired Golden State Bancorp, parent company of First Nationwide Mortgage and Cal Fed, the second-largest U.S. thrift.
- Between 2002 and 2005, Citi spun off Travelers.

The result: These and scores of other takeovers, mergers, divestitures, and partnerships between and among Wall Street firms essentially eradicated employee, management, and executive loyalty to any given institution. Replacing the "old school" purposefulness of long-term business builders such as John Reed of Citibank, Harvey Golub of American Express, Sanford Weill of Citicorp, and even Richard Fuld of Lehman Brothers, was a new brigade of short-term "money tacticians" who seemed to care little about the prestige, financial soundness, and long-term success of their employers. The only thing that motivated them was making money—any way they could.

In the late 1990s and early 2000s, the likes of Stan O'Neal of Merrill Lynch, Anthony Mozilo of Countrywide, and Kerry Killinger of Washington Mutual set the stage for a new way of doing business in the financial markets; one defined by a credo of "take no prisoners."

The mentality that governed the way subprime home mortgages were underwritten and approved in the years leading up to the financial crisis encapsulates this myopic "make-the-numbers" driver of pre-crisis financial services management.

This mindset was rather astoundingly summed up by James LaLiberte, former Chief Operating Officer People's Choice Bank a California-based subprime lender which filed for bankruptcy protection in 2007 and court-administered liquidation in 2008. LaLiberte told NBC News that People's Choice's chief appraiser had commented to him that "Fraud is what we do," referring to the bank's reported practice of approving loans based on fictitious home appraisals as well as egregiously falsified mortgage applications.

People's Choice is thus a perfect example of how mortgage lending became a vast playground for unscrupulous loan brokers, lenders, appraisers, underwriters, and executives. Another People's Choice employee—an underwriter—told NBC News that she was actually bribed by loan salespeople with cars, cash, and even breast implants in exchange for approving loan applications that were clearly doctored and were for borrowers who had no way of making the loan payments. (She said she declined these offers).

Unsurprisingly, People's Choice's founder and former CEO, Neil Kornsweit denied any knowledge of such nefarious activity, but such was the position of hundreds of top executives of failed or struggling subprime lenders who at least tacitly sanctioned out-of-control sales conduct by loan officers, appraisers, and underwriters.

A Triangle or a Diamond?

In recent years a few variations on the Fraud Triangle theory have emerged among antifraud professionals. They have been dubbed the "Fraud Diamond" or "Fraud Pentagon" due to the inclusion of additional psychological motives for employees to commit fraud.

In one interpretation of the evolution of a Fraud Diamond, the fourth part of the shape is closely related to rationalization. It occurs when an employee justifies committing a fraud by taking the attitude that he *deserves* the stolen money—because the company was unfair in denying him a raise or promotion, or that some other form of mistreatment made the individual a "victim."

Unfortunately, if we accept Callahan's argument that the cheating culture is well entrenched in America, we must also accept that the fourth element of the Fraud Diamond—employee disenfranchisement—will not be easy to counteract and that it will continue to gnaw at the ethical foundations of our culture.

This is especially so in light of the seemingly more important pressures—such as sustaining revenues and profits—that, as discussed earlier, weigh excessively on top decision makers. However, downplaying the importance of this management duty can result in costly fraud.

A Fraud Pentagon?

The People's Choice example, as well as the transformation of Wall Street from venerated standard bearer of international financial integrity to hotbed of numbers-chasing mayhem, provides background for a variation of the Fraud Diamond Theory discussed earlier.

It cannot be denied that in the period from 1999 until the onset of the financial crisis in mid-2007, unadorned lust for money became a root cause of the debacle.

The cycle fueled by Wall Street securitization of billions of dollars of fraudulently processed and default-prone loans which generated outlandish paydays for everyone from top Wall Street executives to Main Street subprime mortgage brokers spread a fog of avarice over the entire financial system, ultimately dooming it to its inevitable crash-and-burn.

The bottom line: By the mid-2000s, the Fraud Diamond, as it applied to the financial services industry, had morphed into a Fraud Pentagon with *personal greed* forming the fifth side of the shape and creating new characteristics and manifestations of the already deeply engrained fraud problem in the financial services industry.

In forthcoming chapters, we'll explore how all of this contributed substantially and directly to the eventual decline and collapse of the financial markets between 2006 and 2009 as well as how America fell from its lofty position of global financial superpower to the crippled welfare recipient of billions of federal bailout dollars.

Notes

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