

A new fraud squad being devised

Colin Read: Everybody's Business

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— Fraud (n) — an act of deception intended to deprive another or others of something of value.

It sounds like the feds are getting serious about financial fraud. They are working on an all-encompassing regulatory agency designed to prevent the abuses that made some billions but cost us all trillions. I can only hope they actually succeed.

The problem is that the financial industry is also helping design the legislation. We have been getting glimpses of the incestuous relationship between the financial industry and those public servants left to regulate them. Even Treasury Secretary Tim Geithner is now under fire over what he knew in his former position as the president of the New York fed, and in his kingpin role in bailing out companies that got a deal from taxpayers almost too good to be true.

In the aftermath of the Enron debacle, the Sarbanes Oxley Act was passed to require publicly traded firms to accurately disclose their finances. We did not ask the likes of Jeffrey Skilling and Kenneth Lay to design the legislation. And yet, Congress is asking some of the same financial "gurus" that got us into this mess how we might design legislation to prevent a recurrence of the global financial meltdown.

I am not sure that Wall Street and K-Street are as troubled by financial fraud as we are on Main Street.

There are some that would argue we should not be chasing after financial fraud at all. This Ayn Rand surrealism has even been advocated by the former chairman of the Federal Reserve, Alan Greenspan. Their argument is based on the premise that markets work most always, and would certainly police themselves to be rid of fraudulent players.

They may even believe the cost of preventing fraud is greater than the costs of the frauds. They might argue there is nothing like a threat of fraud to keep us attentive to our own financial affairs. I believe even Alan Greenspan is skeptical of this spurious argument now.

I won't hang my argument on the unfairness of fraud. Just like beauty is in the eyes of the beholder, what is fair and equitable depends on one's position. If what is fair to one is evil to another, there is no objective criterion that can label as true the position of one or the other.

Instead, economists argue that fraud is unjustifiable for another reason. Just as we prefer people to invent rather than simply take, dare I say steal, the inventions of others, we cannot condone fraud. We are most productive when we actually produce, not when we work to expropriate the production of others.

Fraud is this very abuse. Effort expended to extract the wealth of others is almost worse than simple theft. At least with theft there is often little effort consumed. With financial fraud, there is much effort, much disinformation, and often, as Bernie Madoff demonstrated, many feelings of resentment, betrayal and

disenfranchisement.

Greenspan's argument is based on the premise that the market seeks out good information and exposes fraudsters. However, he may fail to acknowledge the costs of our ever-vigilance in sniffing out frauds that can lurk around any corner.

This is a year in which we have discovered fraud of almost \$100 billion. In this same year, the budget for the Securities and Exchange Commission, the primary financial-fraud watchdog, was less than a billion dollars. Our losses from fraud in a single year amount to a century of investment in the detection of fraud. Other damages aside, it is obvious to everybody that we do not invest enough to catch the bad actors.

Unfortunately, with such fraud in financial markets comes cynicism, mistrust and a lack of faith in markets. This damage is very difficult to overcome, and tears at the very fabric of the market place. Ultimately, we are all singed by the flame of financial fraud.

Greenspan may also believe that market transparency is the equivalent of turning over every rock and exposing fraud before it can take hold.

I actually agree with such transparency. It is an obligation of healthy markets and healthy management to keep people informed of the deliberations and the decisions that affect us all.

A lack of transparency is often argued as a necessary element of strategic thinking. However, few strategic decisions require such secrecy. Actually, more strategic decisions would be improved through greater transparency and inclusion.

Of course, transparency tends to reduce the takings of winners and the sacrifices of losers in any action or decision. In a world viewed as a constant sum game and a winner-take-all jackpot, transparency removes the windfall to those on the inside.

More importantly, transparency allows solutions that a closed room of insiders could not have imagined. Transparency creates synergy while secrecy and fraud create cynicism and resentment.

It is such considerations of synergy and positive sum games that fraudsters underestimate. Those who would engage in fraud view it almost like a sport. They rationalize that if they were denied the fruits of fraud, these fruits would simply go to someone less deserving.

We see this same gaming mentality among lobbyists in Washington. Commentators on the CNBC financial network recently reported that lobbying efforts have doubled since the onset of the Great Recession. Lobbyists know change is in the air, and want to be positioned ideally to either be immunized from change or capitalize from the profits of change. When change is necessary, it is unproductive of each of us to ensure only others must change. Such lobbying holds us all back.

From mortgage markets to credit-card markets, securities markets to student-loan markets, mutual-funds managers to hedge funds, there is plenty to be done to get things working again. I certainly wish that the world that once earned Alan Greenspan's unblinking faith could actually be attained. However, we are moving farther away from that world all the time. In a simpler, less anonymous financial world, perhaps transgressions would be easier to detect.

More problematic, we have discovered that growth is now manufactured on paper, not in factories. This paper growth can be distorted, invented, stolen and misrepresented. It would have been much harder to fake the old fashioned production borne of the sweat of one's brow. Our economy would also be much better for it, too.

It is difficult to know just what will emerge from talks of the formation of a fraud squad. However, if the quality of partisan bickering in Washington is any indication, I will be pleasantly surprised if what emerges will help prevent the next global financial meltdown. Our economy, and the world economy, depends on successful legislation.

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