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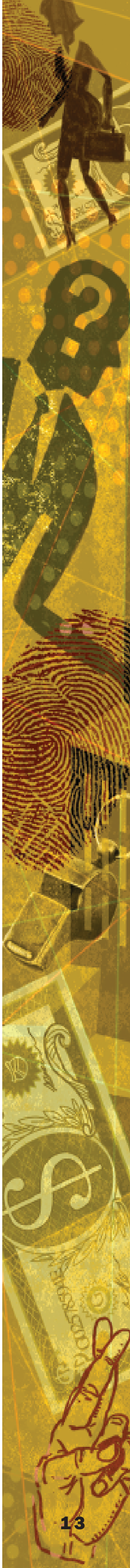

Does the Fraud Triangle Apply to the Credit Crisis?

Despite all the regulatory oversight from various state and federal agencies, the current credit crisis shows that adequate controls weren't in place to ensure the safety and soundness of the banking industry.

The three components of the fraud triangle—pressure, perceived opportunity, and rationalization—were first described by criminal sociologist Donald R. Cressey in his book *Other People's Money: A Study in the Social Psychology of Embezzlement*. It's more than coincidence that the same three factors appeared to be present when the subprime mortgage disaster began to wreak havoc on the banking system and economy.

Pressure to perform fraudulent acts can involve financial needs, but it also results from employee relationships with their employer or the desire to "keep up" with the performance of peers. Acts are rationalized (e.g., "Everyone else is doing it") or occur in an environment over which the individual has no control. The opportunities for fraud are always around us, but they usually involve inadequate internal controls. If given the opportunity, individuals may be motivated to do whatever is required to meet an employer's expectations or personal requirements, committing fraud because "the system" doesn't prevent it.

Whether excessive subprime lending and the subsequent securitization of such mortgages into collateralized debt obligations (CDOs) sold to investors constitute fraud is an issue for the courts to determine. Regardless, the three fraud components were present in subprime loans as mortgage brokers and bank lenders flooded the market with mortgages that seemed quite obviously destined to result in default. Capital for the loans was provided by investment bankers who packaged them into highly rated products and easily sold them to unsuspecting investors worldwide.

The three fraud components are interrelated, but this column will focus on the impact of poor controls on the crisis—the perceived opportunities for wrongdoing. In the case of subprime lending, banks received incentives to grant mortgage loans of any quality so long as they could be securitized with a high credit rating and sold to others so the loans wouldn't show on the banks' balance sheets. In other words, banks profited by persuading lower-income borrowers to pile on unaffordable, high-interest debt, which the banks then securitized and sold to unsuspecting investors. Interests of shareowners and the general public were ignored. Some have called this behavior exploitative greed and nearly the same as organized crime. And now taxpayers are being asked to pay the bill for the excesses of this environment.

Perhaps the most troubling aspect of the subprime lending crisis is that it involves the banking industry, probably the most highly regulated industry in the United States. In addition to state regulators, there are the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and, in the Treasury Department, the Office of Comptroller of the Currency and the Office of Thrift Supervision. Each of these agencies provides oversight and had the power to direct changes in policies and practices. Several also have auditors who visited banks periodically to examine records and ascertain that requirements were being followed.

Additionally, Congress created the Federal Financial Institutions Examination Council (FFIEC) in 1978 to promote consistency in the examination and supervision of banking organizations. The primary objective of the supervisory process is to evaluate the overall safety and soundness of banking organizations. This includes an assessment of the organization's risk management systems, financial condition, and compliance with applicable banking laws and regulations. The rating system for banks is commonly referred to as CAMELS, an acronym for the six components of the rating system: capital adequacy, asset quality, management and administration, earnings, liquidity, and sensitivity to market risk. This should permit regulators to focus on institutions with the lowest ratings and take action to protect depositors.

Also illustrative of the cause of today's crisis is the failure to learn from the banking and thrift collapses in the late 1980s, which resulted in the passage of the FDIC Improvement Act of 1991 (FDICIA). The previous regulatory structure encouraged banks to take on additional risk at greater moral hazard. Poor enforcement by regulators delayed the imposition of sanctions and corrective action on troubled institutions. Among other provisions, FDICIA provided for the establishment of safety and soundness standards and initiated the requirement for management evaluation of internal controls with external auditor attestation, a provision that was extended to all public corporations by the Sarbanes-Oxley Act (SOX).

The current crisis demonstrates that the most important objective of the resulting regulatory structure—preserving the safety and soundness of the banking industry—wasn't achieved. Bankers recognized, took advantage of, and profited greatly from Washington's relatively hands-off approach that began in the early 1980s and accelerated in 2001. Although the tools to prevent catastrophe were available, regulators didn't use them effectively.

A description of how federal regulators had become a foe in the fight to rein in reckless real estate lending is contained in "The Watchdogs Who Saw Disaster Coming—and How They Were Thwarted by the Banks and Washington" (*Newsweek*, October 20, 2008). As early as 2003, state attorneys general tried to protect their citizens from the dangers of rash mortgage loans only to have Washington undercut their efforts. According to Roy Cooper, attorney general of North Carolina, federal authorities "took 50 sheriffs off the job [when] the mortgage lending industry was becoming the Wild West."

As noted in this column in December 2007 ("Who Should Be Blamed the Most for the Subprime Loan Scandal?"), credit rating agencies conferred investment-level grades on new mortgage investment products that were obviously based on loans of dubious quality. The role of credit rating agencies was critical to the very existence of the securitization and rapid growth of the subprime lending market.

These agencies didn't limit themselves to expressing an expert "independent" opinion regarding the creditworthiness of a new product. They also set the standards that securities had to meet to be highly rated and were paid as advocate consultants to guide issuers in how best to meet those standards. This is the same conflicted position in which Arthur Andersen found itself with respect to the outrageous accounting for Enron's exotic special purpose entities.

Considerable blame for the credit rating agency aspects of the subprime debacle rests at the door of the Securities & Exchange Commission (SEC), which was assigned oversight responsibility of credit rating agencies in the Credit Rating Agency Reform Act of 2006. The SEC initially failed to require meaningful changes and didn't get serious about this new responsibility until June 2008, when it began to issue a series of proposed regulations.

The new rules were designed to address concerns about the integrity of credit rating procedures and methodologies in the light of the role they played in determining the ratings for securities collateralized by or linked to subprime residential mortgages. Unexpected defaults in highly rated mortgage-backed securities are believed to be a major underlying cause of the credit crisis. Comments by the agencies that their ratings are only as good as the information given to them by issuers (which the agencies don't disclose) further diminishes their value.

In December 2008, one important final rule was issued prohibiting credit rating agencies from structuring the products they rate. Also prohibited are gifts over $25 and persons participating in both determining credit ratings and negotiating or discussing fees. Additional agency record-keeping requirements also were issued, such as including the rationale for any material difference between a rating for a structured finance product implied by a quantitative model and the final rating. These actions are very modest beginnings.

Other rules proposed in June and July 2008 weren't adopted. Previously, the SEC required money-market funds to invest only in securities having the highest credit ratings. A proposal would have eliminated this requirement. SEC Chairman Christopher Cox stated the action was designed to have "investors make an independent judgment of the risks associated with a particular security" rather than merely relying on a rating.

The effect of this ruling would have diminished the importance of ratings instead of taking action to boost the credibility of ratings and reliability of the rating process. It's hard to see how investors are better protected by telling them they should rely on their own investigation rather than on that of a designated expert. This would be similar to telling investors not to rely on an independent audit rather than improving the quality and reliability of the audit itself. Also not adopted in December were controversial proposed rules differentiating credit ratings by category of investment, specifically noting a difference between ratings of commercial bonds and structured finance investments.

In July 2008, the SEC also released a report of an investigation of the three most prominent credit rating agencies that shows significant weaknesses in the rating agencies' processes for rating investments linked to subprime residential mortgage-backed securities. It's interesting to note that the SEC is expressly prohibited by law from regulating "the substance of the credit ratings or the procedures and methodologies" by which any rating agency determines its ratings.

Let's hope that the lessons of the current credit crisis will lead to regulatory reforms promoting ethical cultures that facilitate compliance with the spirit and objectives of the securities laws—integrity, full disclosure, and trust. Unfortunately, SEC Chairman Cox's December 2 open letter to CEOs of SEC-registered firms speaks only of compliance "with the law and rules for industry participation." This legalistic approach minimally describes prohibited actions and only invites planning to "get around the rules." Compliance doesn't drive ethical behavior, but a strong ethical culture does lead to compliance.

The Federal Sentencing Commission has it right by requiring organizations to have an ethical culture. When will the SEC realize the importance of ethics? **SF**

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