

# FINANCIAL FRAUD: A LITERATURE REVIEW

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**Abstract.** This paper describes the empirical universe of financial fraud as it has been documented in the academic literature. Specifically, it describes the different forms of fraudulent behaviour in the context of financial market activities, the prevalence and consequences of such behaviour as identified by previous research, and the economic and market structures that scholars believe facilitate it. To structure the discussion, a conceptual distinction is made between three types of financial fraud: false financial disclosures, financial scams, and financial mis-selling. The findings of the literature review highlight a number of recent developments that scholars think have facilitated the occurrence of financial fraud, including (1) the development of new fundamental conflicts of interest and perverse incentive structures in the financial industry; (2) an influx of unsophisticated, gullible participants in the financial marketplace; (3) the increasing complexity involved in financial market transactions as a result of rapid technological, legal, and financial innovation and an ever-widening menu of financial products; (4) an increase in the use of justified secrecy in the form of a mystification of trading models adopted by fund managers.

**Keywords.** financial fraud; financial misconduct; financial crime; securities fraud; financial statement fraud; financial scams; financial mis-selling; white-collar crime

## 1. Introduction

This paper explores the phenomenon of fraud in the financial services industry. Increasingly, it appears, fraud has moved from the fringes of the financial market activity to become a type of behaviour that is widespread throughout the industry. Despite the clear observability of this trend in the news media and its obvious empirical implications, mainstream academic research on financial markets has until now largely failed to account properly for this trend. As a first step in bringing the phenomenon of financial fraud closer to the centre of academic research on financial markets, this paper describes the empirical universe of financial fraud as it has been documented in the literature across a wide variety of disciplines.<sup>1</sup> The main purpose is not to present an all-encompassing analysis of the literature on financial fraud, but to provide a descriptive account of the different forms of fraudulent behaviour in the context of financial market activities,<sup>2</sup> the prevalence and consequences of such behaviour as identified by previous research, and the market structures that scholars believe facilitate this behaviour.

Before presenting the results of the literature review, it might be useful to demarcate the boundaries of the phenomenon under study. Fraud is a complex and elusive concept, both as a behavioural category<sup>3</sup> and as a legal one. In the context of financial market activities – banking, securities, and insurance – however, fraud can be attributed a more specific meaning and is best understood as the unlawful falsification or manipulation of financial information (Fligstein and Roehrkasse, 2013). Financial information acts as the linchpin for financial market transactions. Participants in financial markets merely exchange intangible rights (and obligations), the present and future value of which depends entirely on the status and future

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performance of the issuer of those rights (Lomnicka, 2008). To assess the current status and future performance of the issuer and ultimately to establish the perceived value of a financial instrument, both accurate information and the expertise necessary to interpret that information are essential.

To facilitate the provision of information to the market, to safeguard the integrity of such information, and to protect market participants that lack the necessary expertise from being exploited by more sophisticated market participants, state authorities issue legal rules – regulatory rules, statutory laws, civil laws, and criminal laws – and prescribe sanctions that are then enforced by the courts and the designated authorities. Three sets of legal rules are of specific significance with regard to the phenomenon of financial fraud. First, to facilitate the provision of information to the market and to ameliorate the problem of information asymmetries, financial regulators have imposed *disclosure requirements* as a central pillar of financial market regulation in all developed financial markets (Seligman, 1983; Coffee, 1984; Mahoney, 1995; Selden, 2006). Disclosure requirements prescribe that issuers of financial instruments and providers of financial services disclose to the market and their counterparties all relevant information, that they do so in a timely manner, and that they make sure that all market participants have equal access to this information.

Second, to protect those financial market participants who are deemed to have insufficient expertise to interpret the available information from being exploited by more sophisticated market players, legal systems may impose *fiduciary duties* or *suitability requirement* on certain market participants. Fiduciary duties and suitability requirement, which exist in both retail (Mundheim, 1965; Lowenfels and Bromberg, 1999; BIS, 2008; Engel and McCoy, 2002, pp. 1317–1363) and wholesale (Schmedlen, 1995; Geckeler, 1996; Roberts, 1996; Pardieck, 2006; Davidoff Solomon *et al.*, 2012) financial markets, prescribe that financial service providers and financial advisers share some of the knowledge and expertise they hold so that clients or customers can make informed decisions with regard to financial transactions. Whether or not a fiduciary duty or suitability requirement applies, as well as the nature and extent of the duty in any particular case, is established by reference to the character of the parties involved in a specific transaction or cooperation and the underlying contractual relationship between those parties.

Third, legal systems prohibit certain deceptive behaviour through *general fraud laws*, which may appear in both civil and criminal bodies of law (Podgor, 1999; Buell, 2006, 2011; Ryder, 2011, pp. 93–139; Harrison and Ryder, 2013, pp. 61–90). In many jurisdictions the law also provides a number of legal statutes that target certain kinds of financial fraud more specifically. Most importantly, financial fraud in the securities markets is usually targeted by countries' securities law regimes. Other statutes may specifically target financial fraud in the banking or insurance sector, fraud perpetrated using mail and wire communications, or fraud perpetrated through the use of a computer or the Internet.

Where financial market participants willingly and knowingly provide the market or counterparties in specific transactions with false, incomplete or manipulative information in a way that violates any of the three sets of legal rules mentioned above we enter the domain of financial fraud. Fraud is thus understood here as a characteristic of a course of action that provides sufficient grounds for a regulatory enforcement action, successful private litigation, criminal prosecution in the courts, or all of these. For the purpose of this study, financial frauds can then be defined as *acts and statements through which financial market participants misinform or mislead other participants in the market by deliberately or recklessly providing them with false, incomplete or manipulative information related to financial goods, services or investment opportunities in a way that violates any kind of legal stipulation, be it a regulatory rule, statutory law, civil law, or criminal law*.

Concrete acts of financial fraud vary widely in their representations, depending on the market segments in which they are perpetrated, the financial instruments they pertain to, and the actors involved. To make the empirical universe of financial fraud intelligible and to structure the survey presented in this paper, a conceptual distinction is made here between three types of financial fraud (see Table 1). The first of these, which will be referred to as *false financial disclosures*, groups together a variety of behaviours in which financial market participants make false statements about the performance or financial health

**Table 1.** A Typology of Financial Fraud.

	Nature of the deception	Nature of the enterprise	Primarily prohibited by
False financial disclosures	Plain lies/mis-statements of facts	Legitimate	Disclosure requirements & General fraud laws
Financial scams	Plain lies/mis-statements of facts	Illegitimate	Disclosure requirements & General fraud laws
Fraudulent financial mis-selling	Misleading impressions	Legitimate/ Illegitimate	Fiduciary duties & Suitability requirements

of an investment outlet – that is a company, fund, borrower, or investment product. Notwithstanding the involvement of plain lies, false financial disclosures pertain to otherwise legitimate enterprises, actors, or products. This distinguishes them from *financial scams*, which constitute the second type of financial fraud. Financial scams are fully fraudulent schemes in which fraudsters induce people to voluntarily interact with the fraudster and, ultimately, to willingly hand over funds or sensitive information related to their personal finances. Like false financial disclosures, financial scams involve plain lies. Differently from false financial disclosures, however, financial scams are designed not as a legitimate enterprise, but as a true confidence game. Finally, *fraudulent financial mis-selling* refers to the deceptive and manipulative marketing, selling, or advising of a financial product or service to an end user, in the knowledge that the product or service is unsuitable for that specific end user's needs. Where both false financial disclosures and financial scams involve plain lies, financial mis-selling practices evolve around suggestive communications that create misleading impressions, but do not involve mis-statements of facts.

It needs emphasis that these are ideal types in a Weberian sense. The boundaries between these categories are blurry and not all real world cases fit neatly and unequivocally within one of the categories. For example, whether a specific communication involves plain lies, and thus qualifies as a false financial disclosure, or 'merely' suggestive statements, and therefore constitutes an act of financial mis-selling, is not always clear-cut. Similarly, it is not always as easy to determine whether a fraudulent act or statement pertains to an otherwise legitimate entity, and thus qualifies as a false financial disclosure, or whether the entity as a whole operates as a financial scam. This indeterminacy of the typology is further augmented by the fact that financial frauds may present themselves as courses of action in which behaviours that fall under different types of financial fraud are combined into elaborate fraud *schemes*.

The paper proceeds as follows. Each of the following three sections of the paper will first spell out in more detail the specific characteristics of one of the above types and then move on to a more detailed description of the specific fraudulent acts that are subsumed under it. Specifically, it will describe how these acts are executed, identify the actors and financial instruments involved, present some estimations on the prevalence of these frauds as well as the social and economic costs and consequences they incur, and explain the market structures and dynamics that facilitate these fraudulent conducts.<sup>4</sup> The conclusion then summarizes the general findings of the literature review and suggests possible directions for future research.

## 2. False Financial Disclosures

The term *false financial disclosures* is used here to group together a variety of behaviours in which financial market participants make false statements about the performance or financial health of an investment outlet – that is a company, fund, borrower, or investment product. False financial disclosures

thus exploit the information asymmetry that exists between different parties in a financial transaction. By combining the illusion of disclosure with false information, false financial disclosures increase this information asymmetry while appearing to minimize it (Black, 2006). Notwithstanding the deceptive element, false financial disclosures pertain to otherwise legitimate enterprises, actors or products. This distinguishes them from investment scams, which are designed as con games from the start. False financial disclosures are also distinct from financial mis-selling practices. Whereas financial mis-selling practices merely create misleading impressions, false financial disclosures disseminate plain lies and untrue facts.

In most cases, false financial disclosures concern misrepresentations made by representatives of an organizational entity. Such misrepresentations may have either one of two objectives. First, misrepresentations may be used to cover up the misuse, misappropriation or misapplication of funds. Organizational insiders who misuse or embezzle funds may alter accounting ledgers and supporting documentation to conceal their deeds. Alternatively, false financial disclosures may be issued by managers to mislead investors or regulators about the financial health and future prospects of an enterprise.<sup>5</sup> Misrepresentations by organizational actors may be communicated through presentations, prospectuses, financial reports, or financial statements with the regulator. Although at times this involves misrepresentations of the nonfinancial characteristics of the company – for example, the credentials or ownership interests of executive management – most often these misrepresentations pertain to the financial health of a company or one of its subunits, as documented in the accounts. Hence, many authors speak of false financial disclosures in organizational contexts more specifically in terms of *accounting fraud*.<sup>6</sup>

Like organizational entities, individuals may also misrepresent their financial affairs. Usually, this is done in an attempt to ensure better terms for a financial contract. For example, loan applicants may make false disclosures about their income, assets, or liabilities in order to induce a lending institution to make a loan it would have otherwise refused. Alternatively, parties seeking insurance may misrepresent a true state of affairs in order to negotiate better terms for an insurance policy.

## 2.1 *Rogue Traders: False Financial Disclosures at the Proprietary Trading Desks of Financial Firms*

One context in which false financial disclosures have repeatedly surfaced over past decades is at the proprietary trading desks of securities firms and investment banks. Securities traders working at these trading desks have repeatedly been found to have manipulated accounts and internal control systems to make their trading activities look either more profitable or less risky than they actually were. Although such ‘rogue traders’ are in no sense a new phenomenon, the 1990s witnessed a remarkable number of consecutive high-profile cases in which financial firms lost billions of dollars. The increasing availability of derivatives at that time not only enabled traders to take trading positions of a size that had previously been unheard of, it also undermined the capacity – or willingness – of senior managers to supervise traders’ trading activities (Hudson, 1998; Krawiec, 2000; Partnoy, 2002). Although arguably rogue traders never truly disappeared from the stage, the aftermath of the financial crisis of 2007–2008 witnessed what one observer acclaimed to be ‘the return of the rogue’ (Krawiec, 2009).<sup>7</sup>

Typically, rogue trader scandals begin with traders executing unauthorized trades that result in trading positions that exceed risk- or loss limits set by the firms they work for (Krawiec, 2000; Fisher QC, 2015). Rather than unwinding their deteriorating positions and accepting losses when they find the market moving against them, rogue traders often extend their unauthorized positions in an attempt to ‘double down’ on their losses. In doing so they accumulate risks and losses up to a point where they find themselves forced to cover up their activities through fraudulent accounting, forged documentation, and active circumvention of internal control systems. In some cases, rogue traders managed to hide their losses over extended periods of time by creatively misrepresenting their true trading activities and deceiving their colleagues

and managers. Toshide Iguchi, for example, managed to hide his losses from his employer – Daiwa Bank – for nearly eleven years (Wexler, 2010).

### 2.1.1 *Prevalence, Costs and Consequences*

Rogue trading scandals have been described as ‘low-frequency, high-impact events’ (Krawiec, 2009). Although the number of detected cases of traders gone rogue is relatively low, the costs and consequences of their schemes can be enormous. A review of the literature reveals that banks victimized by rogue traders found themselves forced to readjust their financial statements, correcting for losses associated with these scandals ranging from \$118 million up to \$7.2 billion. At times, rogue trading scandals may even constitute a direct threat to the stability and existence of established financial institutions (Krawiec, 2009). For example, the British investment bank Barings, which had been in business for more than 200 years, was instantly brought down when the rogue trading activities of one of its derivatives traders at the bank’s Singapore branch, Nick Leeson, were uncovered, resulting in losses of over a \$1 billion (Kane and DeTrask, 1999; Körnert, 2003).

### 2.1.2 *Perpetrators, Motivations and Opportunities*

In trying to understand what drives some traders to cross the boundaries of what is permissible, scholarly research has focused on a number of themes. One of these themes concerns the ‘psychological picture’ of traders (Laffort and Cargnello-Charles, 2014). In general, these individuals are described as risk-seekers who are ‘motivated by the rewards, both intrinsic and extrinsic, of pushing outwards into the danger zone where others do not have the skills to operate’ (Wexler, 2010, p. 4). They often do not see their activities as rooted in a casino-like notion of chance but insist that they have special skills that allow them to beat the odds and stay in control in the midst of growing uncertainty, disorder and chaos (Wexler, 2010).

Another theme concerns the working environment and incentive structures in which these actors operate. The stereotypical image of the rogue trader is that of a deviant actor, an undersocialized member of an occupational community where most members do not cross the line. In the scholarly literature; however, this image of the rogue trader as a ‘bad apple’ has repeatedly been challenged (Krawiec, 2009; Wexler, 2010; Laffort and Cargnello-Charles, 2014). Instead it is suggested that the securities industry induces traders to cross the line. It has been emphasized that traders are not only in charge of enormous sums of corporate funds, enabling them to make profits for the firm, they are also encouraged to use these funds to maximize their own wealth in the form of year-end bonuses (Krawiec, 2000). It has also been said that traders are strongly driven by a pursuit of esteem and status, and the trading floors on which they operate have been described as ‘superstar environments’, where a disproportionate share of benefits is accrued by the star trader. These benefits not only come in the form of higher bonuses and intrinsic rewards. Equally important, managers confer benefits on superstar traders in the form of more accommodating risk and loss limits and less scrutiny in terms of oversight (Krawiec, 2000; Stein, 2000; Wexler, 2010). Traders, it is suggested, thus feel quite invited by their employees to cross the line (Wexler, 2010).

A third theme concerns the lack of controls to prevent traders from perpetrating their harmful schemes. Managers typically explain failures to detect rogue trading activities by the fact that rogue traders possess insider knowledge which allows them to draw up sophisticated cover-up schemes and cleverly bypass internal controls. For example, Jerome Kerviel, whose rogue trading activities caused his employer Société Générale a loss of \$7.2 billion, was said to have relied on his intimate knowledge of back-office operations, which he had acquired while working there, to perpetrate his scheme. The academic literature, however, rather emphasizes the absence of effective managerial oversight in many security firms. The literature is rife with examples of management’s failures to see, or at least act upon, obvious red flags. For example, a major warning sign ignored by Société Générale was that Jerome Kerviel’s earnings grew sixfold between

2006 and 2007, instantly amounting to a substantial percentage of total desk (59%) and division (27%) earnings (Krawiec, 2009). Another example of an often-ignored warning sign is the reluctance of traders to take vacations – presumably for fear that their fraud will be detected. In one extreme case, Toshide Iguchi of Daiwa Bank refused to take a single day off during his eleven-year tenure at the bank (Krawiec, 2009). The literature proposes three reasons for which managers may refrain from questioning their star traders. First, proprietary trading has the potential to bring enormous profits to the company, resulting in large bonuses not only for traders, but also for their superiors (Krawiec, 2000; Weber, 2011). Nick Leeson, whose name has become almost synonymous with the term ‘rogue trader’, would himself say that the biggest crime he was guilty of was trying to protect people and ensure that the bonuses they expected were paid (Leeson, 1996). A second reason for which managers may refrain from scrutinizing their star trader stems from group psychological dynamics at work amongst an organization’s senior management. It has been suggested that senior managers of financial institutions that face a crisis because of changes in their external environment may vest all their hope of getting out of the crisis in one star trader. Those senior managers may then create an organizational structure and culture that gives that star trader great leeway and in fact encourages him to ‘go rogue’. The star trader is thus identified as a ‘saviour’ who, when sufficiently left alone, can individually ‘rescue’ the organization (Stein, 2000). Third, because of the increasing complexity of proprietary trading activities, largely due to the spread of derivative instruments, managers are said to not fully comprehend their subordinates’ activities (Hudson, 1998; Instefjord *et al.*, 1998; Partnoy, 2002; Körnert, 2003).

## 2.2 *Mortgage Origination Fraud: False Financial Disclosures in the Context of Loan Applications*

In the housing bubble that preceded the financial crisis of 2007–2008, a significant undercurrent of financial crime existed in the form of mortgage fraud. Analytically the mortgage industry can be thought of as consisting of two distinct segments. In the ‘primary mortgage market’, mortgage originators, with the interference of brokers, escrow agents, and appraisers, originate and provide loans to borrowers. In the ‘secondary mortgage market’, investment banks, government-sponsored enterprises, and credit rating agencies engage in the business enterprise of securitizing and managing loans originated in the primary mortgage market (Collins and Nigro, 2010; Nguyen and Pontell, 2010). As will be revealed below, fraud has been rampant in both segments of the mortgage industry.

In the literature, fraudulent behaviour in the primary mortgage market is generally discussed under the heading of *mortgage fraud*, (e.g. Carswell and Bachtel, 2009; Barnett, 2013) or *mortgage origination fraud* (e.g. Collins and Nigro, 2010; Nguyen and Pontell, 2010). Mortgage origination fraud has been defined as ‘the material misstatement, misrepresentation, or omission by an applicant or other interested parties, relied upon by an underwriter or lender to fund, purchase or insure a loan’ (FBI, 2007, cited in Nguyen and Pontell, 2010, p. 592). Mortgage fraud consists of a great variety of behaviours. A common thread running through all such behaviour is that the purpose is to induce a lending institution to make a loan it would have otherwise refused (Gans, 2011). Following government authorities and industry organizations, researchers usually group these different types of behaviour under two broad categories: *fraud for housing* and *fraud for profit*.

Fraud-for-housing schemes are relatively straightforward. They involve loan applicants who make minor misrepresentations, usually on a single loan, with regard to their income, employment status, or outstanding liabilities. This is done in the hope that a lender will fund the loan or will provide a better rate on a loan for a property of primary residence. Ultimately, however, the borrower intends to repay the loan. Fraud-for-profit schemes are often more complex. They typically involve multiple loans and elaborate schemes designed to gain illicit proceeds from property sales and real estate transactions. They are usually perpetrated by a number of cooperating parties, which may include mortgage brokers, home appraisers, and so-called ‘straw borrowers’, who make gross misrepresentations concerning appraisals,

**Table 2.** Common Fraud-for-Profit Schemes (adopted from Carswell and Bachtel, 2009).

Fraud offenses	Description
Illegal flipping	Seller inflates the value of the property using an illegitimate appraisal. Once the mortgage is delivered, the home is then sold with the mortgage taken over by another buyer, who unwittingly believes that the house is of higher quality than it truly is. Ultimately, the buyer is left to repay a high mortgage on a property whose mortgage value exceeds the market value, a situation which usually results in default.
Real estate title fraud	Through identity theft, a mortgage fraud perpetrator is able to secure a mortgage loan using an assumed identity and presumably an untarnished credit file and history.
Straw buyer	Similar to the title fraud offense, a strawbuyer is someone who has knowingly given credit information to an interested party for a fee, usually totalling several thousand dollars. Months after the mortgage fraud has been committed, the straw buyer is left with the outstanding mortgage, much to his or her surprise.
Silent second mortgages	Buyer of the property borrows the down payment through an undisclosed second mortgage (usually through the seller). If the second mortgage is not recorded, this can allow the seller to inflate the actual value of the house, beyond its market value.
Foreclosure rescue/equity skimming	This situation occurs when a financially strapped homeowner is urged to sign over the deed of the property to a 'specialist' who can help sell the house quickly, sometimes with an upfront fee involved. The rescue buyer may collect rents on the property without making any mortgage payments. This forces the lender to foreclose on the property, holding the original owner and mortgage holder liable in the process
Air loans	The property in question is either misrepresented, does not exist, or is not what the loan says it is. The dishonest broker fabricates borrowers and properties, creates accounts for payments and maintains custodial accounts for escrows.
Double sales scam	This form of fraud occurs in areas where the recording of the transactions takes several weeks to several months. In essence, the owner of the house (who may operate under the guise of a shell company) takes advantage of this delay in deed recording to sell the home more than once. When the ruse is uncovered, actual title to the property becomes cloudy as a result.

loan documents, and even the identity of the borrower. Of the two, fraud-for-profit schemes are of greater concern to law enforcement and the mortgage industry (Nguyen and Pontell, 2010). Table 2, adopted from Carswell and Bachtel (2009), lists some common fraud-for-profit schemes.

Mortgage origination fraud is believed to have been a major contributor to the collapse of the subprime mortgage market in the United States and the subsequent global financial crisis of 2007–2008 (Nguyen and Pontell, 2010; Baumer *et al.*, 2013; Ryder, 2014). Investigations into the causes of these events revealed that fraud was rampant throughout the entire industry, especially the subprime sector, during

the pre-crisis boom in the US housing market. In fact, the FBI had already identified the threat to the financial system posed by increasing levels of mortgage origination fraud in 2004. However, since the Bush administration had prioritized the tackling of terrorism over that of white-collar crime, both the agency and the Department of Justice lacked the resources to respond because all resources were being devoted to the war on terror (Ryder, 2014). Although these priorities were reversed after the collapse of the subprime mortgage market in 2007 and the start of the Obama administration in January 2009, rates of mortgage fraud did not really decline. Perpetrators simply adapted to the changed market conditions by developing new schemes and modifying older ones. As a result, even in the postcrisis period, mortgage fraud has been said to be ‘the number one white collar crime in the United States’ (Smith, 2010, p. 473).

### 2.2.1 *Prevalence, Costs and Consequences*

There is wide agreement in the literature that the period from the late 1990s until today has witnessed an explosion of mortgage fraud, especially in the United States<sup>8</sup> (e.g. Smith, 2010; Ryder, 2014). The most frequently used indicator for the prevalence of mortgage (origination) fraud in the United States is the number of mortgage-related Suspicious Activity Reports (SARs) filed with the US Treasury Department’s Federal Financial Crimes Enforcement Network (FinCEN).<sup>9</sup> In a 2006 report, FinCEN reported that this number has increased by approximately 1400% over the period between 1997 and 2006 (FinCEN 2006, cited in Nguyen and Pontell, 2010). This number has continued to rise since the collapse of the subprime mortgage market. In 2011, FinCEN received 92,028 SARs, up from 37,313 for the period 2006–2007 (Ryder, 2014). The continuing pervasiveness of mortgage origination fraud also becomes clear if one considers law enforcement actions. Already in 2006, the FBI warned that mortgage fraud was ‘pervasive and growing’ (FBI 2006, cited in Barnett, 2013, p. 110). The subsequent years witnessed a 400% increase in the number of mortgage fraud-related investigations undertaken by the FBI (Ryder, 2014). In 2008, the FBI reported that it was investigating 14 corporations as part of its Subprime Mortgage Industry Fraud Initiative (Nguyen and Pontell, 2010). In that same year, ‘Operation Malicious Mortgage’, a multiagency enforcement action, identified more than 400 defendants associated with \$1 billion in losses. Two years later, the Financial Fraud Enforcement Task Force completed its enforcement action called ‘Operation Stolen Dreams’, which involved 1517 criminal arrests, resulting in 525 indictments that represented estimated losses of over \$3 billion (Barak, 2012).

Estimates of the monetary costs of mortgage origination fraud fall within a wide range and are difficult to compare. For example, while the US Mortgage Bankers Association has estimated that fraud costs the mortgage industry between \$946 million and \$4.2 billion in 2006 (Mortgage Bankers Association 2007, cited in Nguyen and Pontell, 2010, p. 593), the Mortgage Asset Research Institute estimated 2008 losses at between \$15 and \$25 billion. However, even though it is difficult, if not impossible to determine the exact monetary cost of mortgage origination fraud (Ryder, 2014), the literature identifies at least three groups of actors for whom such fraud has serious economic consequences. First, mortgage origination fraud results in direct losses to *lenders* and *investors* through higher default rates on loan portfolios. For example, Piskorski *et al.* (2013) found that loans with a misrepresented borrower occupancy status or misreported second lien have a significantly higher likelihood to default when compared with otherwise similar loans. Because these higher risks are hidden, the authors emphasize, they are not compensated for in terms of higher yields. Second, mortgage fraud poses adverse economic consequences for *tax payers* (Gans, 2011). Through securitization and derivatives trades, the hidden risks associated with mortgage origination fraud are spread throughout the financial system. Ultimately, these systemic risks are borne by taxpayers who pay for bailouts. Third, mortgage origination fraud has significant consequences for *homeowners* and *communities*. High levels of mortgage fraud in a given geographical area have been



found to be a significant predictor of foreclosures in that area as well as in bordering areas (Nguyen and Pontell, 2011; Baumer *et al.*, 2013).

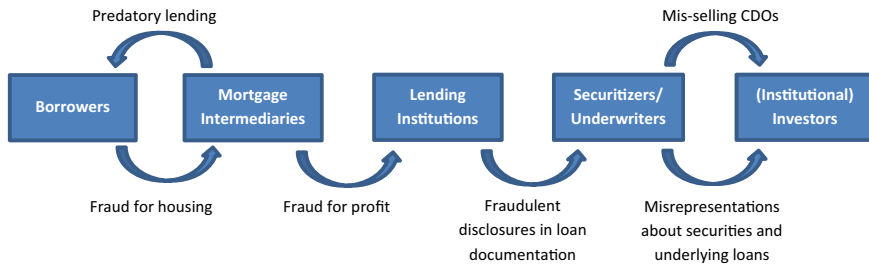
### 2.2.2 *Perpetrators, Motivations and Opportunities*

The primary perpetrators of mortgage origination fraud can be divided into two groups. First, *loan applicants* themselves are often involved. According to a 2008 analysis by FinCEN, about 60% of all reported mortgage fraud involved the willing participation of borrowers (FinCEN 2008, discussed in Gans, 2011, p.148). However, it is important here to distinguish between fraud-for-housing and fraud-for-profit schemes. In the case of the former, the involvement of loan applicants is obvious. In order to secure a loan, genuine applicants misrepresent their financial health or employment status. In fraud-for-profit schemes the situation is different. These schemes often involve ‘straw borrowers’ – persons who have knowingly conveyed their identity and credit information to other perpetrators of the scheme for a fee, usually totaling several thousand dollars – or perpetrators who, through identity theft, assume someone else’s identity and untarnished credit file and history (Carswell and Bachtel, 2009, p. 350).

The second group of primary perpetrators are *mortgage industry intermediaries*. According to the FBI, 80% of all reported mortgage fraud losses involve collaboration or collusion by mortgage industry insiders (FBI, 2007, cited in Smith, 2010, p.479). This includes corrupt mortgage brokers, real estate appraisers, escrow agents, title officers, builders and land developers (Collins and Nigro, 2010; Gans, 2011). Scholars have pointed out that for corrupt intermediaries mortgage fraud schemes constitute a ‘low-risk and high-return activity’ (Gans, 2011, p.150). Especially prior to the collapse of the US housing market, there was much to gain and little to lose for those involved in mortgage fraud. Before it collapsed in 2006, the mortgage industry, and especially the subprime part of it, represented an enormous and growing industry,<sup>10</sup> making it a tempting target for fraudsters. At the same time, perpetrators had little to fear, neither from law enforcement agencies – sentences were light and the chance of getting caught was low<sup>11</sup> (Smith, 2010, p. 475) – nor from the lending institutions that they seemingly victimized with their devious schemes. In fact, as will be discussed below, these lending institutions acted as important facilitators of mortgage origination fraud.

### 2.3 *Mortgage Securitization Fraud: False Financial Disclosures in the Context of Structured Finance Investments*

Mortgage origination fraud was only the beginning of a chain of lies that ran through the entire mortgage industry (see Figure 1). In the secondary mortgage market, investment banks, acting as underwriters for securities issued by structured investment vehicles, have been accused of making false statements to investors and other market participants about the quality and character of those securities (Barnett, 2013; Fligstein and Roehrkasse, 2013; Piskorski *et al.*, 2013). Structured investment vehicles are contractual entities that pool portfolios of loans – residential mortgages, student loans, car loans etc. – and then issue bond-like securities for which the principal and interests paid on those portfolios of loans serve as collateral. The process of issuing these structured finance products – primarily residential mortgage-backed securities (RMBSs), asset-backed securities (ABSs) and collateralized debt obligations (CDOs) – usually involves, besides the issuer, the service of an underwriter. The job of the underwriter, most often an investment bank, is to raise capital from institutional investors who are willing to invest in the security issued by the structured investment vehicle (Fligstein and Roehrkasse, 2013). It has been found that, during the pre-crisis boom, many underwriters misrepresented the characteristics of these securities and the quality of the loans underlying them to investors and sellers of insurance on those securities – issuers of so-called credit default swaps (CDSs). This included misrepresentations about the quality of the loans in the portfolios that provide collateral for these securities – for example fraudulent property appraisals,



**Figure 1.** Chain of Lies in the Mortgage Industry [Colour figure can be viewed at [wileyonlinelibrary.com](http://wileyonlinelibrary.com)] The lower part of the figure identifies instances of false financial disclosures in the US mortgage industry prior to the financial crisis of 2007–2008. The upper part identifies instances of mis-selling in that same industry.

Predatory lending will be discussed in more detail in Section 3.1 of this paper. For a discussion of the mis-selling of CDOs, see Reurink (2016, pp. 73–76).

misrepresented loan-to-value ratios, misstatements about the sort of loans underlying the security, and misrepresentations about the delinquency status of the loans in the portfolio – or misrepresentations about the credit rating on them.

### 2.3.1 Prevalence, Costs and Consequences

False financial disclosures in the context of structured finance investments were especially widespread in the United States, the epicentre of the subprime mortgage boom. According to one observer, ‘almost all the prospectuses and sales material on mortgage-backed bonds sold from 2005 through 2007 were a compound of falsehoods’ (Ferguson, 2012, p. 191). Recent legal developments seem to support such allegations. It has been reported that the top 10 underwriting firms, which together represented 74.1% of the market share, have all been implicated in securities fraud cases. Eight of them have settled with regulators or investors over underwriting-related fraud allegations (Fligstein and Roehrkasse, 2013). Academic attempts to quantify the prevalence of false financial disclosures in the underwriting of structured finance products point in a similar direction. Piskorski *et al.* (2013) found that about 1 out of every 10 loans in their dataset involved some sort of misrepresentation. These misrepresentations existed across all underwriters involved in the sale of RMBSs.<sup>12</sup>

The ultimate victims of the fraudulent misrepresentations by underwriters were the unsuspecting investors that bought the RMBSs, ABSs and CDOs – that is midsized European banks, public pension funds, and hedge funds (Ferguson, 2012; Nesvetailova and Sandu, 2015). Although in their defence banks have maintained the opposite, in the literature it is generally assumed that these buyers were not as ‘sophisticated’ as the investment banks that sold these products, giving the latter an informational advantage in the transaction (Piskorski *et al.*, 2013). In their earlier mentioned study, Piskorski *et al.* found that misrepresentations by underwriters had significant economic consequences for these investors. The delinquencies of misrepresented loans were 60–70% higher than the delinquency rate of otherwise similar loans, potentially impacting RMBSs with a combined outstanding balance of up to \$160 billion (Piskorski *et al.*, 2013).

### 2.3.2 Perpetrators, Motivations and Opportunities

The primary perpetrators of mortgage securitization fraud were the *broker-dealers* who worked for the investment banks and brokerage firms that underwrote, marketed, and sold these complex investment

products to institutional investors. As underwriters, investment banks have a legal obligation to perform due diligence on the loans they receive from originators before selling them on to investor. In fact, the prospectus of a structured finance security such as a RMBS or CDO typically assures investors that, prior to acquiring the loans, the underwriting firm would conduct a review of the seller of the loans – its credit risk, its senior-level management, its mortgage loan origination processes, historical loan level loss experiences etc. (Barnett, 2011). As we now know, they often failed to do so. In the literature, the failure to perform due diligence has generally been explained as a result of the structures of *competition* and *compensation* in the mortgage industry. Under the so-called ‘originate to distribute’ (OTD) model, originators and lending institutions passed most of the risks associated with the mortgages they originated along to securitizers, who in turn passed the risks on to bullish and often naïve investors. Under the OTD model securitizers thus generated most of their revenues from fees rather than returns on investment. Hence they were principally concerned with volume, rather than quality, that is whether or not the loans that went into the securitization products were well documented or likely to be repaid (Fligstein and Roehrkasse, 2013). Compensation structures for the individual investment bankers who engineered and marketed the securitized loans largely mirrored the motivations of their firms to deal deceptively in high quantities of low-quality debt (Barnett, 2011; Fligstein and Roehrkasse, 2013).

Notwithstanding the fact that legal liability for misrepresentations in the context of structured finance investments rests primarily with the banks that securitized and underwrote these products, actors from outside the banks have been involved in these schemes as well. Attention has especially focused on the role played by the credit rating agencies (CRAs) in mortgage securitization fraud (Bussani, 2010; Dorn, 2011; Maas, 2011; Barak, 2012). In February 2013, the US Department of Justice filed civil charges against Standard & Poor’s (S&P) for allegedly engaging in a scheme to defraud investors in RMBSs and CDOs. Civil fraud claims against the CRAs have also been filed by private litigants. Most of these claims allege that the agencies fraudulently inflated their ratings of structured finance investment products, and that the CRAs lied to investors about their independence and objectivity in the construction of those ratings. Academic scrutiny of the involvement of CRAs in securitization fraud has especially problematized the business model and limited accountability, especially in criminal law, of the CRAs (Bussani, 2010; Johansson, 2010; Cane *et al.*, 2012; Lehmann, 2014).

### 3. Financial Scams

*Financial scams* are deceptive and fully fraudulent schemes in which fraudsters, often assuming a false identity or exhibiting a misplaced aura of trustworthiness, convince, mislead, or induce people to voluntarily interact with the fraudster and, ultimately, to willingly hand over money or sensitive information related to their personal finances.

Financial scams do not simply victimize their targets by exploiting existing information asymmetries that could impossibly have been bridged by the victims. In most cases, cautious investors could have easily known or found out that the opportunity or invitation was a scam (Pressman, 1998). The skill of the con artist lies in the ability to induce the investor to make a leap of faith. Financial scams are thus different from financial mis-selling practices in that they go beyond misleading and suggestive communications. Financial scams are built on blatant lies and completely fabricated facts. Financial scams are also different from false financial disclosures in that, unlike the latter, they are designed not as a legitimate enterprise, but as a true confidence game.<sup>13</sup>

Genuine financial scams typically proceed according to a well-delineated pattern. First, the potential victims – the ‘marks’ – must be approached and their interest piqued. The mark’s attention may be caught by offering high returns at low risks or by threatening that the mark’s bank account will be shut off if the mark does not cooperate. The perpetrators of the scam – the ‘operators’ – may communicate this message in different ways. In some cases, operators work with lists that contain telephone numbers or e-mail addresses of individuals, usually people with high disposable incomes or individuals who have

been successfully defrauded before (Shover *et al.*, 2004; Policastro and Payne, 2014). Such ‘lead lists’ or ‘mooch lists’ can be easily purchased on the Internet for a relatively small price. In other cases, scam artists take advantage of affinities and social networks, which quickly generate interest in the scam by word of mouth (Baker and Faulkner, 2003; Nash *et al.*, 2013). Affinity relationships between the scammers and their victims may also play an important role in the second step, in which operators try to garner trust (for a detailed discussion of the construction of trust in the Madoff Ponzi scheme see Stollowy *et al.*, 2014). In this phase scam artists may hijack trusted brand names and misrepresent themselves as being representatives of legitimate companies. Finally, the marks must be enticed to participate in the scheme. To undercut the marks’ perceived need for due diligence, operators appeal to trust and visceral triggers. They may, for example, appeal to the marks’ greed or distressed financial situation by promising high returns and stressing the need to make the decision urgently.

### 3.1 *Investment Scams: Sham Business Ventures and Ponzi Schemes*

Investment scams are fraudulent schemes that try to deceive investors into investing their money in a specific investment opportunity that, in fact, is nonexistent or that will most certainly not live up to expectations. Such investment opportunities may consist of shares, equity stakes, or debt issued by fake or dubious companies, often backed purportedly by a hot new product, technology, or business opportunity. Alternatively, investment scams might offer participations in collective investment vehicles, real estate projects, or insurance plans.

Investment scams can be designed in either one of two ways. In some cases the operators of the scam simply collect the money and then disappear. Investment scams designed in this way frequently make use of shell companies registered in secrecy jurisdictions. The anonymity provided by these jurisdictions enables the operators to collect the money and then disappear without leaving any traces for duped investors to recover their losses (Tillman, 2002). In most cases, however, investment scams are designed to live a longer life and take the form of a *Ponzi scheme*. Ponzi schemes are often characterized as investment scams wherein investors’ returns are generated by capital coming in from new investors rather than the success of the underlying business ventures. A somewhat more nuanced understanding of Ponzi schemes, however, recognizes that the rollover of investments made by new investors is not the only mechanism that helps to keep the scheme going. Often, operators provide earlier investors with fictitious paper earnings<sup>14</sup> that are then re-invested in another investment cycle (Frankel, 2012; Lewis, 2012). Thus, in Ponzi schemes the returns promised to investors do in fact materialize initially, at least on paper. However, even though the seeming realization of returns enables Ponzi schemes to last for some time without being discovered, in the long run they are doomed to collapse; as soon as new investors stop joining or earlier investors want to redeem their investments and/or paper profits, the scheme starts to collapse (Trahan *et al.*, 2005).

To lure victims into participating, investment scams appeal to a variety of needs and emotions such as greed, ego, the fear of losing opportunities (Will, 2013). Typically, they draw the marks’ attention with promises of steady returns, often above the market rate, at low risk. The exact rates of return vary widely between schemes. There are examples in the literature of scammers offering returns of up to 40% within six to eight weeks, or 100% within a month (Frankel, 2012). On the other hand, the scheme perpetrated by Bernard Madoff, supposedly the largest Ponzi scheme ever, offered investors modest but steady returns of 10–12% per year, regardless of market conditions (Nolasco *et al.*, 2013).

The success of investment scams also depends on an effective diffusion system. This is especially pertinent in the case of Ponzi schemes, which need a constantly expanding investor base to survive. The literature identifies two different ways in which the investment opportunity is made known among investors. First, the scam can be disseminated through *impersonal methods*. Operators of investment scams may use paid sales forces to promote the scam. They may, for example, recruit telemarketing teams to run through mooch lists or salesmen to go from door to door to sell a certain ‘investment opportunity’

(see Baker and Faulkner, 2003; Shover *et al.*, 2003; Shover *et al.*, 2004). Also, con artists may recruit registered broker-dealers who advertise the fund or company with their clients. Ponzi schemes that play out in the fund industry may recruit so-called ‘feeder funds’: investment advisers and money managers, backed by prominent financial institutions, who direct their clients’ funds directly towards the Ponzi fund (Lewis, 2012). For example, established financial institutions throughout the world had been known to accept payments from Madoff for recruiting investors (Frankel, 2012). Second, the scam might be promoted to investors through word-of-mouth within *social networks* (Baker and Faulkner, 2003; Comet, 2011; Nash *et al.*, 2013). Frequently, such scams take the form of an ‘affinity fraud’ (Perri and Brody, 2012; Blois, 2013), in which operators take advantage of a shared identity with the victims, be it as part of a religious organization (e.g. Bernard Madoff), an immigrant community (e.g. Charles Ponzi), exclusive clubs, or simply a group of family or friends. Often a fortunate group of early investors become the ‘songbirds’ that sing the praises of the scam to others. To provide credibility and induce the songbirds to bring friends, family members or business colleagues into the scam, operators make regular dividend payments to those early investors, giving the scam an appearance of profitability and legitimacy (Frankel, 2012; Lewis, 2012).

### 3.1.1 *Prevalence, Victims, Costs and Consequences*

Discussions of investment scams in the financial press tend to focus on rare high-impact cases. Examples are the multibillion-dollar schemes operated by Bernard Madoff and Allen Stanford. However, the scholarly literature on investment scams is rife with examples of smaller and less well-known albeit for the victims equally destructive scams. Investment scams appear to be so pervasive that some have even suggested they have reached the proportion of an epidemic (Frankel, 2012). In the years 2008 and 2009 alone, 190 Ponzi schemes collapsed in the United States (Lewis, 2012, p. 294), and a 2007 study conducted by the Canadian Securities Administration noted that about one in twenty Canadians had been victimized by investment fraud (CSA, 2007, cited in Lokanan, 2014, p. 226).

Although precise figures on the monetary costs associated with investment scams are scarce, they are generally believed to be significant. For example, the costs associated with global investment fraud in the year 2001 have been estimated to be around \$35 billion (Frankel, 2012). The majority of these costs fall on those who invested their money in the scheme. However, investors are not the only ones injured by investment schemes. Victims may also include financial institutions that have unwittingly facilitated the scheme. For example, feeder funds that directed their clients to the scheme not knowing it was a scam, brokerage firms that executed transactions for the Ponzi fund, and banks that offered accounts to the operator etc. These institutions might be affected in their daily operations and often suffer from tainted reputations (Frankel, 2012).

### 3.1.2 *Perpetrators, Motivations and Opportunities*

Operators of investment scams tend to exhibit certain character traits. On the one hand, con artists are said to be charming and captivating individuals (Lewis, 2012). On the other hand, they are said to frequently have a narcissistic character and to lack any concern or empathy for their victims, sometimes even blaming them for being duped into the scheme (Frankel, 2012). Their motivation is often intrinsic and comes from more than greed alone. They may have grandiose dreams of making a fortune but also of gaining recognition and respect. In pursuing their dream, they behave very much like legitimate entrepreneurs and might even believe their scheme to be true ‘businesses’ (Frankel, 2012). This not only helps to make the investment opportunity appear ‘trustworthy’ in the eyes of investors, a crucial element of a successful investment scam (Stolowy *et al.*, 2014), it also explains a tendency amongst operators

of investment scams not to want to see certain things, such as the unsustainable structure of the scheme (Naylor, 2007).

It has been suggested in the literature that a number of institutional arrangements in present-day finance capitalism are especially conducive to investment scams. Building on Robert K. Merton's theory of the anomic society, some scholars have pointed to *the American dream* as a factor driving both perpetrators and victims of investment scams (Trahan *et al.*, 2005; Young, 2013). Most importantly, they point at the way in which the American dream emphasizes the importance of success and de-emphasizes the methods of acquisition. Scholars have also indicated the way in which investment scams take advantage of institutionalized practices in financial markets. In the hedge fund industry, where the mystique of alpha returns reigns supreme, trading models are generally clouded in secrecy for fear that competitors will imitate them. Perpetrators of investment scams take advantage of this *justified secrecy*, using it primarily to keep investors at bay and avoid detection (Frankel, 2012; Blois, 2013; Shapiro, 2013; Stollowy *et al.*, 2014). It has also been suggested that *technological advancements* have given fraudsters a greater range of vehicles and opportunities to perpetrate investment scams. Especially the Internet has reduced the need to finance a large sales force, and the anonymity it provides shields con artists from detection (Frankel, 2012). Finally, the success of investment scams has also been said to depend on a *lack of efficient oversight*. At one level, scholars have pointed to the lack of serious scrutiny by external auditors (Geis, 2013; Shapiro, 2013). At another level, observers have emphasized the failure of regulatory authorities to police the market and detect, at an early stage, large-scale investment scams such as those perpetrated by Bernard Madoff and Allen Stanford (Markopolos, 2010; Shapiro, 2013). An interesting point in this regard is that regulatory investigations are usually theory-driven, that is to say, investigators do not approach a case with an open mind but with a hypothesis in mind. This may direct their attention away from what they should be looking for. In the Madoff case, for example, the SEC had been tipped off by a hedge fund but was blinded by the idea that Madoff was engaged in insider trading (Lewis, 2012).

### 3.2. *Financial Identity Scams: Phishing, Pharming and Payment Scams*

The term *financial identity scams* is used here to refer to fraudulent schemes that try to induce potential victims to hand-over personal identifying information related to their financial accounts and credit scores. Once the operator has succeeded in inducing the mark to surrender the information – which may include account numbers, credit card details, passwords, user IDs etc. – the operator then uses this information to perform fraudulent money transfers. Thus understood, the term financial identity fraud refers to both the *obtaining* of the victim's financial identifying information, often through scam-like schemes, and the subsequent fraudulent *use* of that information for financial gain.

To obtain the identifying information, operators of financial identity frauds use different techniques. In the literature, a conceptual distinction has been made between *technical subterfuge schemes* and *social engineering schemes* (Vittal, 2005; Button *et al.*, 2014). *Social engineering schemes* contact their marks with 'spoofed' e-mails – e-mails with forged sender-addresses – that prompt recipients to visit counterfeit websites designed to trick them into divulging their financial identity voluntarily. The most common social engineering scheme technique is what is called *phishing* (see Lynch, 2005; Jagatic *et al.*, 2007). In a typical phishing scheme, the operator, pretending to be an agent from a bank or credit card company, sends out e-mails in which he prompts customers of the bank to click on a hyperlink that brings them to a website, controlled by the phisher, where they will be asked to further process their account details (Vittal, 2005). To appear credible and to trick the recipient's into participating in the scheme, the scam artist's e-mails may contain company logos or use scare tactics – such as threats of account closure – and urgency cues that short-circuit victims' elaboration on clues that could reveal the deceptive nature of the invitation (Lynch, 2005; Vishwanath *et al.*, 2011).

*Technical subterfuge schemes*, in comparison, are more technical in nature and rely much less on persuasion to entice victims into the scheme. This enables a much wider victim base. For example, in what is generally referred to as *pharming* (Vittal, 2005; Brody *et al.*, 2007), fraudsters send out e-mails which, when opened, plant malware – malicious software – in the victims' personal computers. The malware then directs traffic from those PCs that is destined for a legitimate website, say, a bank, to the pharmer's bogus website, which looks just like the real one. Without the victim's knowledge or consent, all the information the victim thinks is being sent to the bank's website is sent directly to the pharmer. Another possible mode of operation for pharmers is to alter a website's Internet protocol (IP) address in the domain name server (DNS). In so doing, pharmers redirect all users who type in the web address of, say, a bank to the illegitimate website controlled by the pharmer.

After having obtained the victim's financial credentials, operators of financial identity scams then fraudulently use this information to realize financial gain.<sup>15</sup> Here, again, operators choose from a menu of different techniques, which can be thought of as falling along a continuum. At the least sophisticated and low-cost end of the spectrum are traditional payment frauds, or credit card frauds, whereby perpetrators make unauthorized use of one or several of the victim's existing bank and credit card accounts by withdrawing cash or buying merchandise. These kinds of frauds are generally detected at an early stage by victims or financial institutions' fraud detection systems and hence are generally limited to a few transactions. At the more sophisticated end of the spectrum are fraud schemes that take longer to be detected and, accordingly, involve much larger costs to the victims. Here, fraudsters not only make unauthorized use of the victim's existing accounts, but open up and deplete new credit accounts and credit lines using the victim's identity, without the victim being aware of it. Between those ends of the continuum are 'account takeover frauds', whereby fraudsters establish complete control over an existing account in order to extract the entire balance in a deposit account or to access the full credit line of a credit account, and 'fictitious identity frauds', in which pieces of real data from one or more consumers are combined with made-up information to fabricate an identity and establish a credit line that does not belong to any real person<sup>16</sup> (Cheney, 2005).

### 3.2.1 *Prevalence, Victims, Costs and Consequences*

There is widespread agreement in the literature that financial identity scams and identity abuses in general constitute a serious and growing threat for financial systems today. Identity abuses have been said to form the number one and fastest growing economic crime in a range of countries as diverse as the United States (Brody *et al.*, 2007; Pontell and Geis, 2007), China (Bai and Chen, 2013) and India (Geeta, 2011). In the United States, losses from financial identity scams have been estimated to be as high as \$49.3 billion for the year 2006 (Javelin, 2007, cited in Epstein and Brown, 2008). In the United Kingdom, estimated losses caused by identity-related crime have been calculated around 1.3 billion British pounds per year. For Australia estimates vary from 1 to 3 billion US dollars (Pontell and Geis, 2007; Ozaki, 2008).

A review of the literature (Vittal, 2005; Brody *et al.*, 2007; Anderson *et al.*, 2008; Ozaki, 2008; Ram, 2008; Geeta, 2011) reveals that the adverse consequences of financial identity scams are born by three groups of victims. The first of these consists of the *consumers and businesses* whose financial identities misappropriated and abused by the fraudsters. Adverse consequences experienced by this group of victims may include having to spend time and money in sorting out the fraud, a loss of access to credit due to credit score deteriorations, as well as psychological and emotional consequences. A second group consists of the *merchants and credit providers* who have been tricked into delivering money or goods based on fraudulent payments. These companies generally bear the costs of investments in fraud detection technologies and may forgo potential revenues due to their refusal to accept valid transactions because they look suspicious or due to growing consumer reluctance to engage in e-commerce. The third group of victims consists of the *banks, credit card companies and e-retailers* whose brand names are hijacked by phishing schemes.

These companies may suffer from costs associated with increased surveillance and prevention as well as negative effects on stock prices and trading volume.

### 3.2.2 *Perpetrators, Motivations and Opportunities*

Financial identity scam operations are organized as highly professionalized, global criminal networks. These networks involve a wide variety of criminal entrepreneurs and exhibit a highly developed division of labour (Lovet, 2006; Brody *et al.*, 2007; Pontell and Geis, 2007; Moore *et al.*, 2009). For example, at the front end of the value chain, where the collection of identifying information takes place, *phishermen* – criminal actors that operate a copy of a genuine bank website – hire *spammers* to drive customers of the bank to their fake websites. In contacting customers, spammers use the services of *botnet herders*, people who manage large collections of virus-infected personal computers that can be controlled remotely under a common command and control infrastructure (Ianelli and Hackworth, 2007). Spammers, phishermen and botnet herders all make use of malware that has been developed by *malware developers*. Once the identifying information has been obtained, the fraudsters may obtain the service of *information specialists* who fill in the gaps when identity data are incomplete. One step further down the line in the ‘production chain’, the fraudulently obtained information might be used in several ways. In the case of traditional payment card frauds, *runners* use the information for online purchases of expensive goods, which are then delivered at the address of a *drop*; someone who allows delivery of items at their home. The drop then forwards the goods to the runner who finally sells them to *complicit retailers* for a price below market value. In other cases, the information obtained by the phishermen is sold to *cashiers*, who use the information to transfer money from the victim’s account to an account controlled by a *money mule*. The money mule fulfils a role similar to that of a drop; he receives and subsequently forwards the money, usually through irrevocable payment services such as Western Union. Both money mules and drops are often duped into cooperating in the scheme. They are recruited via job ads sent in spam e-mails or on websites, where they have been offered opportunities to work from home as ‘transaction processor’ or ‘sales executives’. After the fraud is discovered, they often become personally liable for the buying and laundering of stolen goods and money.

A number of developments are believed to have facilitated the proliferation and professionalization of financial identity fraud. To begin with, information and communication technologies, most notably the networked computer, have created *new channels* through which financial identities can be fraudulently obtained. Especially the proliferation of electronic means for personal banking and the rise of e-commerce are believed to have opened up new ways of perpetrating financial identity scams and allowed these scams to be perpetrated on an industrial scale (Pontell and Geis, 2007; Smith, 2010). Parallel to this, the *economic value of identifying information* has increased significantly. In this regard, scholars have pointed to the specific nature of modern payment systems, and specifically to the increased reliance on identification in those systems (Anderson *et al.*, 2008; Ozaki, 2008). In response to this, organized crime groups increasingly look at identifying information as profitable business opportunity (Smith, 2010). Thus, it has been maintained that another important reason for the proliferation and professionalization of online identity fraud is the *increased involvement of organized crime groups*, which has greatly increased the financing available to hackers and other scam artists (Brody *et al.*, 2007).

## 4. **Fraudulent Financial Mis-Selling**

The term *fraudulent financial mis-selling* is used here to refer to the deceptive and manipulative marketing, selling or advising of a financial product or service to an end user, in the knowledge that the product or service is unsuitable for that specific end user’s needs. Similar to the other forms of fraud discussed here, fraudulent mis-selling practices illegally exploit information asymmetries that exist between transacting



parties. In the case of mis-selling, however, this information asymmetry is of a different character. It involves not so much an asymmetry in access to financial facts directly related to the transaction, but rather an asymmetry of more general financial expertise, that is, the capability of interpreting the available information and extracting meaning from that information with regard to the future performance of a financial product. Contrary to false financial disclosures and financial scams, mis-selling cases thus do not necessarily involve false representations of facts. At the heart of fraudulent financial mis-selling are deceptive sales practices in which the seller of a financial product or service or the financial adviser advising on it makes misleading and highly speculative statements with regard to the future performance of the products or service and/or fails to communicate in a balanced manner the suitability of the financial product or service for the specific end user.<sup>17</sup>

Fraudulent mis-selling practices are generally perpetrated by agents who fulfil a double role as sales agent and adviser in financial transactions. In its most innocent form, mis-selling involves cases in which such agents – direct salesmen, brokers, financial advisers, broker-dealers – provide their clients with unsuitable advice because they lack the advisory competence required by regulations. More devious and fraudulent forms of mis-selling, and of primary concern in this section, involve cases in which sales agents and financial advisers abuse their role by deceptively inducing clients to engage in financial contracts that, given full information and devoid of behavioural and cognitive biases, they would not have engaged in. Especially in the retail financial market, the relative ignorance and limited financial literacy of most consumers puts the sales agents at a considerable informational advantage. Mis-selling agents exploit this informational advantage by providing their clients with biased advice or utilizing aggressive and manipulative marketing strategies.

The financial products involved in financial mis-selling practices typically have relatively far-off horizons and complex contract structures and therefore are associated with high levels of uncertainty. Typically, these are financial products that provide insurance against possible life- or market-events in a relatively distant future. Examples of such products are pension saving plans, life insurance plans, interest rate swaps, or foreign exchange swaps. Because the benefits of such products for the user only become clear long after the transaction has taken place, determining whether a certain product is beneficial for the consumer involves a lot of guesswork and speculation. Through misleading promotional materials, high-pressure sales techniques, and inaccurate or suggestive statements, mis-sellers overemphasize beneficial scenarios, while underemphasizing those that are less beneficial to the buyer.

Although mis-sellers typically target relatively ‘unsophisticated’ investors – most often retail consumers or small and medium enterprises – increasingly mis-selling practices target more sophisticated market players as well.<sup>18</sup> Especially derivatives have proven to be useful instruments for investment bankers attempting to ‘out-mathematize and sweet-talk’ (Goldmann, 2010) supposedly sophisticated clients into deals they really don’t understand.<sup>19</sup>

#### 4.1. *Predatory Lending: The Mis-Selling of Mortgage Loans*

The mis-selling practices that have probably received most attention in the recent literature are those that have been associated with the selling of mortgage loans. Commonly referred to as *predatory lending*, the mis-selling of mortgage loans involves a wide range of practices that include charging excessive fees; steering borrowers into bad or unaffordable loans that net higher profits; inducing a borrower to repeatedly refinance a loan in order to charge high points and fees (Nguyen and Pontell, 2011; Barnett, 2013).

In the majority of cases predatory lenders target subprime borrowers with little prior experience in the credit market (Engel and McCoy, 2002; Delgadillo *et al.*, 2008). They capitalize on these borrowers’ limited financial literacy and lack of access to unbiased financial advice (Engel and McCoy, 2002). Descriptions of the predatory lending process described in the literature suggest that the predatory lending process can be divided into three phases: the *solicitation phase*, the *closing phase*, and the *exploitation phase*. In the solicitation phase, predatory lenders conduct aggressive door-to-door solicitations in target

neighbourhoods. In this phase they ‘endear themselves with charm and solicitude that mask their guile. They consciously exude an aura of expertise and success, intimidating customers from questioning the advisability of the loans they are offering’ (Engel and McCoy, 2002, p. 1283). During the loan closing that marks the second phase of the predatory lending process, predatory lenders impose on these borrowers exploitative loan conditions that often differ from what the borrowers thought they would get, based on their communications with the lender in the solicitation phase. To induce borrowers to sign their overpriced and overly risky mortgage loan contracts, predatory lenders create excessively complex contracts and make use of consumer psychology (McCoy, 2005; Willis, 2006). For example, predatory lenders may persuade borrowers to close a deal as soon as possible under the pretext that their opportunity to borrow will soon vanish (Engel and McCoy, 2002, p. 1283). In the final exploitation phase, the ‘friendly veneer’ with which predatory lenders have initially approached their victims yields to aggressive exploitation of the precarious situation that the loan contract got the borrower into. Often this is where a new round of high-pressure solicitations to refinance the loan starts (Hill and Kozup, 2007).

#### 4.1.1 *Prevalence, Costs and Consequences*

The diversity of practices subsumed under predatory lending, the different credit markets involved, and the lack of a common definition of predatory lending make it difficult to quantify its prevalence and costs. There is, however, a shared understanding in the literature that, at least in the United States, predatory lending practices were widespread during the housing boom that preceded the financial crisis of 2007–2008 and that hundreds of thousands of homeowner have been victimized in the past decade (Willis, 2006; Fligstein and Roehrkasse, 2013; Ryder, 2014). Interestingly, a review of the literature on the phenomenon reveals that scholars had already identified the problem of widespread predatory lending practices and their adverse social and economic consequences well before the financial crisis of 2007–2008 (e.g. Engel and McCoy, 2002; Renuart, 2004; Willis, 2006).

Quantifications of the monetary costs of predatory lending are similarly hard to find. One estimate for the United States suggests that predatory lending of all kinds – including predatory lending by payday lenders, credit card companies, and the like – costs borrowers \$25 billion annually. A 2001 report by the Coalition for Responsible Lending estimated that excessive fees and interest rates alone cost those US borrowers who fell victim to predatory lending specifically in the area of mortgage loans around \$9 billion annually (Stein, 2001). Given the fact that predatory lending practices often trick borrowers into loans they cannot actually afford, the ultimate social and economic costs associated with predatory lending come in the form of increased foreclosure rates (Ryder, 2014). These costs go beyond those who have obtained a predatory loan and may affect entire communities and neighbourhoods (Engel and McCoy, 2002; Ryder, 2014). In this process, the elderly, poor and minority populations are said to be hit the hardest (Engel and McCoy, 2002; Nguyen and Pontell, 2011).

#### 4.1.2 *Perpetrators, Motivations and Opportunities*

The main perpetrators of predatory lending practices in the mortgage industry are mortgage brokers and mortgage originators who, driven by fees and enabled by significant information asymmetries between lenders and borrowers, an abundance of credit, and a lack of regulatory oversight, took advantage of vulnerable borrowers. Incentives structures that in the literature are believed to have motivated predatory lenders are similar to the ones that have been discussed in relation to mortgage origination fraud. The OTD model that prevailed in the mortgage industry operated under a fee structure by which mortgage brokers and originators profited from maximizing the volume of the loans they originated, irrespective of loan quality. Moreover, as Fligstein and Roehrkasse (2013, p. 27) point out, ‘when brokers were compensated in terms of yield-spread premiums – the difference between the rate charged and the par rate

– brokers had incentives to inflate that rate through deception or discrimination. When mortgage brokers were compensated through fees, they had incentives to conceal add-ons and penalties'. Under such a compensation structure, brokers and originators thus have obvious economic incentives to originate as many loans as possible, to refinance them as often as possible, and to originate loans with high interest rates, irrespective of whether this was in the best interest of borrowers, and irrespective of whether borrowers would be able to carry the burden of their debts over the long run.

Predatory lenders have been greatly facilitated in their egregious practices by two major changes in the mortgage industry that have taken place over the last few decades. First, widespread *securitization* of subprime mortgage loans made possible a constant flow of money to the subprime mortgage market and allowed nonbank lenders to enter that market. This resulted in the rise of thinly capitalized and barely regulated mortgage banks that were not regulated by financial institution regulatory agencies and have relatively little to fear from reputational risk (Engel and McCoy, 2002). Indeed, the majority of cases of predatory lending are said to have occurred among such independent mortgage banks<sup>20</sup> (Delgadillo *et al.*, 2008; Nguyen and Pontell, 2011). Moreover, for mortgage lenders, the increased availability of funds opened up the possibility to serve a new market segment of 'subprime' borrowers who had previously been excluded from the credit market because of credit rationing and discrimination. Most of these borrowers were inexperienced and had low levels of financial literacy, resulting in a substantial information asymmetry between lenders and borrowers in the subprime market (Engel and McCoy, 2002). In reaching out to these new borrowers, mortgage lenders, facilitated by the deregulatory policies of the industry's regulators and governmental policies that aimed at increasing homeownership, engendered a *proliferation of mortgage products* that were difficult for inexperienced and unsophisticated borrowers to understand. This further impaired the decision-making capacity of borrowers (Willis, 2006). The combined result of the proliferation of products and the lack of financial literacy amongst the new class of borrowers was a further increase in information asymmetries ready to be exploited by unscrupulous mortgage lenders (Engel and McCoy, 2002; Willis, 2006).

#### 4.2 *The Mis-Selling of Life Insurance and Pension Schemes*

Another segment of the financial services industry that has been repeatedly plagued by episodes of large-scale mis-selling is the life-insurance and private pensions industry. Widespread mis-selling of life insurance and pension plans resulted in major scandals and regulatory actions in the United States in the 1980s (Fischel and Stillman, 1997; Eglar and Malak, 1999), in the United Kingdom in the 1990s<sup>21</sup> (Black and Nobles, 1998; Ryley and Virgo, 1999; Schulz, 2000; Ward, 2000) and in the Netherlands<sup>22</sup> and India in the 2000s (Anagol *et al.*, 2013; Halan *et al.*, 2014).

Previous research on the abovementioned mis-selling scandals suggests that they all occurred against the backdrop of a gradual withdrawal of government support for state pension provision and a secular move away from traditional, collective 'defined benefit' pensions towards personal 'defined contribution' accounts, which essentially are investment products based on the investment performance of an underlying portfolio (Black and Nobles, 1998; Ryley and Virgo, 1999; Ericson and Doyle, 2006; Mitchell and Smetters, 2013). Governments in those countries allowed, through legislation, and encouraged, through tax incentives and advertising, individuals to substitute personal pension plans provided by life insurance companies for collective occupational pension schemes. To facilitate the provision of personal pensions by private companies, governments coupled the reforms with a deregulation of retail financial services sectors, allowing all sorts of financial institutions to provide an increasingly large menu of pension plans (Black and Nobles, 1998). The political rhetoric behind these reforms was one of increased efficiency and flexibility of pension systems, enhanced individual control over life savings, higher returns, and decreased government pension costs (Schulz, 2000). In reality, however, the reforms turned out to create the perfect conditions for widespread mis-selling of life insurances and pensions.

Existing literature also identifies a number of market dynamics that played a role in the abovementioned scandals. In all cases, life insurance companies experienced an intensification of competition as government deregulatory policies allowed banks and other financial services providers to enter the life insurance market. The entrance of new competitors into the industry prompted life insurance companies to rapidly expand their sales forces and adopt more aggressive sales techniques (Black and Nobles, 1998; Egler and Malak, 1999). In an attempt to sell as many plans as possible, poorly trained sales agents driven by perverse incentives exploited consumers' ignorance about pension and life insurance products on a massive scale. In many cases, sales agents did not sufficiently inquire about the risk profile of the client, failed to properly explain risks, created overly optimistic projections of the future performance of the plans, or failed to properly disclose charges and commissions. Sales agents particularly exploited the uncertainty stemming from the strong investment component of personal pension plans, which significantly increases the guesswork and speculation involved in establishing the suitability of the plan for the specific consumer. A widespread practice in the industry, for example, is to have sales agents suggest that, thanks to the investment component of the plan, the product would pay for itself over time (Ericson and Doyle, 2006). In reality, however, consumers frequently ended up seeing much of their premiums leak away to hidden costs and fees, subtracting from the amount of capital over which return can be achieved and resulting in investment results that failed to meet expectations.

#### 4.2.1 *Prevalence, Costs and Consequences*

Although it has been suggested in the literature that mis-selling in the life insurance industry is widespread (Ericson and Doyle, 2006), exact numbers concerning the prevalence and monetary costs of the phenomenon are hard to come by. As Ericson and Doyle (2006) point out, it is often difficult to discern when or how often the deceptive behaviour of insurance salespeople might violate the law. In many cases, plan holders of mis-sold insurance plans are themselves not even aware that they have been victimized. Nor do regulatory investigations provide much conclusive results with regard to the exact scope of the problem. This is due largely to the fact that only a case-by-case examination can determine whether a product has been fraudulently mis-sold.

However, whatever estimates can be found in the literature do indicate that the scale of the problem is considerable, both in terms of the number of victims involved and the costs associated with it. For example, a review of life insurance selling practices in the United Kingdom during the early 1990s, commissioned by the UK securities market regulator at the time, found that 91% of a representative sample of files failed to prove substantial compliance (Ryley and Virgo, 1999). More specifically, the review found that 61% of the files indicated that the adviser did not adequately determine the investor's risk profile, 85% of the files showed no evidence of alternative pension arrangement having been considered and in only 23% of the files was there an adequate analysis supporting the recommendation (Black and Nobles, 1998). It is generally assumed that around 2 million people were involved in the scandal, which involved costs totalling some £11 billion (Ward, 2000). In an audit study on the advice given by financial advisers in the Indian life insurance market, Anagol *et al.* (2013) found that in 60–80% of the cases agents provided unsuitable advice. The costs associated with this scandal have been estimated at \$28 billion (Halan *et al.*, 2014). However, such estimates focus primarily on the costs associated with fines and customer redress, which are borne by shareholders of mis-selling firms. Excluded from such estimates are the emotional and psychological costs associated with the economic insecurity that plan holders have to cope with as a result of mis-sold life insurance products (Schulz, 2000; Tombs, 2013).

#### 4.2.2 *Perpetrators, Motivations and Opportunities*

Scholarly research enumerates a number of factors that have contributed to the 'institutionalization of deceptive sales in life insurance' (Ericson and Doyle, 2006). With regard to the supply side of the market,

scholars have pointed to the remuneration of life insurance agents. The earnings of sales agents are said to be based almost exclusively on *commissions*, creating a strong incentive to adopt aggressive marketing techniques and to sell the highest commission product rather than the product that is most suitable for the consumer (Black and Nobles, 1998; Ericson and Doyle, 2006). Another factor that has been highlighted in the literature is the facilitating effects of an *aggressive sales culture* that prevails in many life insurance companies. Agents, it has been suggested, 'face a constant barrage of motivational messages aimed at augmenting their production' (Ericson and Doyle, 2006, p. 1005). Embedded in these messages are a number of beliefs, or interpretive frames, that are thought to facilitate, if not encourage, mis-selling among agents (MacLean, 2008). Scholars have, for example, mentioned the way in which customers are depicted by agents as perpetually underinsured (Ericson and Doyle, 2006; MacLean, 2008) and the way in which compliance regulations are described in formal company documents as empty rituals (MacLean, 2008). Third, scholars have named vulnerabilities in the *recruitment, training and supervision of sales agents* as a source of mis-selling practices (Black and Nobles, 1998; Ericson and Doyle, 2006). In what has been referred to as a 'revolving doors' policy, insurance firms capitalize on agents' networks of sales prospects and then cut them loose when their networks are exhausted, so that 'recruitment is not based on the recruit, but on the prospect list that the recruit can come up with among his family and friends' (Ericson and Doyle, 2006, p. 1003). One consequence of such a policy is that life insurance sales agents generally go through little training, and what little training time they do have is used primarily to focus on sales techniques and the specificities of the firm's in-house products, rather than on life insurances in general or the requirements of regulatory rules and compliance procedures relating to the selling process.

The demand side of the market has also been said to feature certain characteristics that facilitate mis-selling by agents. One issue that repeatedly comes up in the literature is the *public ignorance* with regard to life insurance products and the investment value of money. Consumers have been said to have difficulties comparing an ever-widening menu of products, all of which involve different risks, potential benefits, and costs (Black and Nobles, 1998; Ericson and Doyle, 2006). It is maintained that life insurance firms and their agents exploit consumers' ignorance by providing them with deceptive projections of the future performance of insurance and pension plans that are based on highly speculative assumptions, by downplaying risks, and by hiding the mechanisms through which fees are charged by the insurance companies (Ericson and Doyle, 2006).

Finally, the literature finds that *regulatory authorities* have done little to ameliorate the problems. Conform to the neoliberal approach to market regulation, regulators have downloaded responsibility with regard to compliance to companies themselves. Regulatory actions have been largely reactive to public complaints, an approach that becomes problematic when the majority of consumers that have been mis-sold life insurance plans are not even aware they have been victimized (Ericson and Doyle, 2006). Even when regulatory institutions did step in, they continued to delegate authority to the industry itself. Rather than punishing and excluding offenders, regulators have generally commissioned firms to internally re-evaluate their sales procedures and identify and compensate possible victims. However, in both the United Kingdom and the Netherlands, the failure of firms to properly redress victims and their attempts to reach secretive agreements with select groups of victims in an attempt to minimize legal costs have led to great public controversy.

### 4.3 *The Mis-Selling of Interest Rate Derivatives*

Because of their complexity and opaqueness, derivatives have proven to be useful devices for mis-selling practices. From the mid-1990s onwards, derivatives have become the subject of a number of mis-selling claims in the securities industry, in which not only retail consumers but also small and medium enterprises and at times even supposedly sophisticated institutional investors have been victimized. One category

of derivative contracts that has repeatedly been involved in allegations of fraudulent mis-selling by financial service firms is the *interest-rate hedging product* (IRHP). IRHPs, colloquially referred to as *interest rate swaps*, are derivative contracts that are intended to protect against interest rate risk associated with an underlying loan. The first accusations of IRHP mis-selling began to emerge in the mid-1990s and involved IRHPs that were allegedly mis-sold to a number of large corporate, and presumably sophisticated, clients of the American investment bank Bankers Trust (Overdahl and Schachter, 1995). A more recent wave of IRHP mis-selling claims emerged in the aftermath of the financial crisis of 2007–2008. In the run-up to the crisis, banks had been targeting much smaller and definitely less sophisticated clients with their aggressive and manipulative derivative-selling practices. Banks in Belgium, the Netherlands, and the United Kingdom, for example, have been found to have mis-sold large numbers of IRHPs to small and medium enterprises (SMEs) and semipublic entities (Zepeda, 2013; Marshall, 2014; Bavoso, 2015).

Many SMEs in those countries had obtained business loans that had floating rates attached to them. To hedge against fluctuations in these rates, loan officers at banks and sales agents advised those SMEs to purchase IRHPs in connection with their business loans. In some cases, the purchase of an IRHP was made a condition for a loan. In their simplest form, IRHPs set a fixed rate and oblige the parties in the contract – the borrower and the bank – to make payments to each other that offset the variability of the interest rate paid on the underlying loan *vis a vis* the fixed rate. When the relevant benchmark rate – and thus the interest rate that needs to be paid over the loan – is higher than the fixed rate agreed upon, the bank pays the difference to the SME. When interest rates fall below it, the SME pays the difference to the bank. Often, however, loan applicants were talked into purchasing the more complex and more risky types of IRHPs. In the United Kingdom, for example, this frequently involved so-called ‘structured collars’.<sup>23</sup>

During the initial period when most of the SMEs signed these contracts, central bank rates were relatively stable (Zepeda, 2013). However, when postcrisis monetary conditions led central banks to drastically lower interest rates to historic lows, many SMEs were prompted to make large and unexpected payments to the banks or to pay exorbitant exit fees to terminate the IRHPs (Zepeda, 2013), causing major financial difficulties for many SMEs. Later, studies into the matter by regulators in different countries revealed that many of the SMEs had been mis-sold the IRHPs by the banks and that large-scale mis-selling had taken place. For example, the FSA, the UK financial regulator at the time, said it had found ‘serious failings’ by several banks in the sale of IRHPs. These concerns related to evidence of inappropriate sales of IRHPs, poor sales practices, poor record-keeping by banks, and sales incentive schemes that were likely to exacerbate the risk of poor sales practices (FSA, 2012, referred to by Zepeda, 2013). It was found that many IRHPs had been ‘over-hedged’ – meaning that the amounts or the duration of the IRHP, or both, did not match the underlying SME loan – and that banks had included excessive break costs – costs to prematurely exit the contract – in the contracts; these costs sometimes exceeded 40% of the value of the underlying loan. Moreover, in many cases sales agents had failed to ascertain the customer’s understanding of these costs as well as other risks involved in the contract (Zepeda, 2013; Marshall, 2014). Another key issue identified by the financial conduct authority in the Netherlands was that banks had not made it sufficiently clear to their clients and customers that they were not acting as advisers in the sale of IRHPs, as they usually do in other transactions with their clients, but merely as sales persons (AFM, 2013). Clients thus assumed the banks were advising them on IRHPs, while in fact the banks were acting as counterparties in an arms-length transaction, which frees them from their fiduciary duties towards clients.

In addressing the issue, regulators in Belgium, the Netherlands and the United Kingdom all urged or forced banks to come to a suitable solution and offer appropriate redress and compensation on a case-by-case basis.<sup>24</sup> To the dismay of many, these solutions allowed banks to settle claims out of court. Thus, claims have been settled privately and away from public scrutiny.<sup>25</sup> Some have suggested that the watering down of findings in regulatory investigations and the low-profile solutions suggested by regulators have

come into being under the pressure of governments and banks, for whom the mis-selling scandals would be 'a scandal too far' (Zepeda, 2013).

#### 4.3.1 *Prevalence, Costs and Consequences*

At the time of writing, not much is said in the scarce literature about the extent of mis-selling of IRHPs. The Dutch regulator has stated that about 17,000 IRHP contracts have been sold to SMEs (FTM, 2014a) and in the United Kingdom this number is estimated at about 60,000 SMEs (Khalique, 2015). However, what proportion of these IRHPs has been fraudulently mis-sold is not clear. In Belgium, the government regulatory agency did not reveal the exact extent of the mis-selling of IRHPs but did say the problem had not reached the proportions it has in the Netherlands and the United Kingdom (FTM, 2015). Nevertheless, an indication of the extent of fraudulent mis-selling that has been offered in the literature refers to a 2012 FSA pilot study. The study, which looked at 173 sales of IRHP to nonsophisticated clients by eight different banks, found that over 90% of these sales did not comply with one or more regulatory requirements (FSA, 2012, cited in Zepeda, 2013).

For individual SMEs, the costs and consequences of mis-sold IRHPs are substantial and have resulted in a great number of bankruptcies. The unprecedented low interest rates in the postcrisis period forced many SMEs to either make large payments to the banks who sold them the IRHP or pay exorbitant exit costs to terminate the contract. These termination costs could amount to 50% of the value of the loan, in addition to the value of the loan itself (Bavoso, 2015). In some cases, SMEs that were unable to make such payments saw their credit lines with the bank being blocked because the negative value of their IRHP was accounted for by the banks as a claim of the bank on the SMEs. The mis-selling episode has also resulted in significant costs to the firms who sold the IRHPs. In the United Kingdom, as of February 2015, banks have already paid out £1.3 billion in redress and compensation (Khalique, 2015). However, despite this large number, it has been argued that redress is unlikely to ensure full and fair compensation for all victims. SMEs face major challenges in providing evidence that they are eligible for redress and, even when they manage to do so, are likely to be grateful for whatever redress is proposed by the banks, even though, according to some, this might be 'considerably less than what they should receive in the interest of fairness' (Zepeda, 2013, p. 11).

#### 4.3.2 *Perpetrators, Motivations and Opportunities*

Reports of regulatory authorities and journalists, as well as the scarce academic literature on the topic, suggest that rewards and incentives for sales agents acted as the main motor driving the mis-selling of IRHPs. Loan officers were subjected to perverse incentives in the form of targets and bonuses to sell as many IRHPs as possible and preferably the types of IRHPs most profitable for the bank in connection with the loans they extended to SMEs (FTM, 2014b; Bavoso, 2015). It has also been emphasized that the mis-selling of IRHPs has been facilitated by the fact that interest rates had been relatively stable throughout the period from 2001 to 2008, the period during which most of the IRHPs were sold. According to one observer, it is possible or perhaps even likely that this stability was used by banks' salespeople to persuade SMEs that the potentially high payment obligations for the knock-in floor strike rate would never be triggered (Zepeda, 2013).

## 5. Conclusion

When recapitulating the literature review presented in this paper, it appears that financial fraud is widespread throughout the financial industry. What makes the pervasiveness of financial fraud especially worrying is the frequent involvement of established financial institutions. Large banks such as

Goldman Sachs and Deutsche Bank, accountancy firms like Ernst & Young and Deloitte, and insurance conglomerates such as Lloyds and AIG, were deeply involved in many of the financial scandals discussed in this paper. The industry itself has usually responded to revelations of their involvement in financial fraud by suggesting that fraudulent dealings are the work of a few bad apples within the organization. The findings of this literature review, however, suggest that the 'bad apples theory' provides a partial explanation at best. Rather, the findings lend support to the criminogenic markets hypothesis (Needleman and Needleman, 1979), which postulates that markets and organizations can be criminogenic in the sense that they structurally facilitate or even promote illegal behaviour. Although the specific market structures and arrangements that have been identified in the literature as being responsible for financial fraud differ between different types of fraud, it is possible to distil from the findings of this literature review four recent developments that are believed to have been important explanatory factors for the occurrence of financial fraud.

First, scholars have repeatedly pointed out the problematic consequences of financial deregulation for prevailing structures of competition and compensation. Financial deregulation has repeatedly been said to have intensified competitive dynamics in previously protected industries and allowed *new fundamental conflicts of interest and perverse incentive structures* to develop in both vertically and horizontally integrated financial conglomerates and throughout industries.<sup>26</sup> Parallel to this, the institutionalization of incentive-based compensation structures (e.g. stock options, bonuses, commission fees) in financial firms, not only at the top but at all levels, has been said to have created perverse incentives throughout the entire financial value chain. As a result, business models of financial firms have become increasingly oriented towards short-term profit-making and stock-price maximization, irrespective of the legal implications of such business models. Fines and other legal penalties are built into such business models as simply a cost of doing business. The incentive problem has been further exacerbated by the introduction of new layers of intermediaries (e.g. fund managers, financial advisers, mortgage brokers, insurance agents) in the financial value chain and the new forms of compensation that have come with it.

Second, over the last few decades financial markets have seen an *influx of relatively unsophisticated investors*. As a consequence of a general trend towards the privatization of social security and the financialization of Western economies, consumers, small and medium enterprises, local governments, and semipublic institutions in those economies increasingly started to engage in financial market activities. The findings of this literature review suggest that this influx of relatively unsophisticated investors has provided fraudulently predisposed and more financially sophisticated market players with a large pool of unexperienced and thus easily exploitable investors. This seems especially to have facilitated the occurrence of a number of large-scale mis-selling scandals.

A third development that has repeatedly surfaced throughout the paper is the *increasing complexity involved in financial market transactions*. Rapid technological, legal, and financial innovation (e.g. derivatives, securitization, special purpose vehicles) and an ever-widening menu of financial products have greatly reduced the transparency, comprehensibility, and controllability of financial transactions and increased the opportunities available to fraudsters to deceive other market participants.

Fourth and finally, the veil of secrecy and mystique surrounding many financial market activities further facilitates the occurrence of fraud in financial markets. The *increased use of justified secrecy* in the form of a mystification of the trading models adopted by fund managers has been on the rise over recent decades. Especially financial scams and false financial disclosures in the context of collective investment funds appear to thrive in this fertile soil of incomplete disclosure.

Most academic work on financial markets to date treats financial fraud as no more than a circumstantial issue with only tangential relevance to a number of mainstream issues. The findings of this literature review, however, suggest that financial fraud deserves to be a mainstream focus in its own right. For economists studying financial markets, there is still much uncovered terrain with regard to financial fraud as a subject for research. A number of directions for future research appear to be especially fruitful. To begin with, future research could look at the impact of fraud on the functioning of markets and



investigate the way in which financial frauds have an impact on the stability of financial systems. Recent research going in this direction (Blanqué, 2003; Sen, 2009; Huisman, 2011; Nesvetailova and Palan, 2013; Nesvetailova and Sandu, 2015) has found meaningful points of departure in the works of Hyman Minsky and Charles Kindleberger. More research could also be done on the political and economic structures that facilitate financial fraud. What has been especially lacking so far is comparative research on the nature and character of financial fraud across different political economic systems. How do levels of financialization of national economies and degrees of institutionalization of financial systems affect the occurrence and control of financial fraud? Also, to what extent does the occurrence of financial fraud differ between different legal systems? Such work could build on existing work in the field of comparative political economy and on literature in law and finance (e.g. La Porta *et al.*, 1998; Coffee, 2005; Deakin *et al.*, 2015). Another interesting issue for future research concerns the relationship between deregulation and financial fraud. What are the causal mechanisms establishing the observed link between deregulation and financial fraud? Finally, economists could study the way in which prevailing interest rates affect the occurrence of financial fraud. To what extent do low interest rates encourage excessive risk taking and facilitate Ponzi-like investment schemes? This question is especially relevant when considered against the backdrop of the secular stagnation thesis, which predicts a sustained period of unusually low interest rates (Summers, 2014).

Recognizing and giving due consideration to the illegal dimensions of financial market activities is essential if we are to further our understanding of the dynamics that drive financial markets and safeguard the integrity and soundness of financial systems in the future to come.

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## Notes

1. A few notes on the scope of the literature review are in order here. First of all, only the English language literature on financial fraud has been included in the literature review. This has had implications for the scope of the findings of the literature review. The English language literature on financial fraud displays a strong bias towards incidences of financial fraud in the financial markets of the United States and Western Europe. This bias should not come as surprise, since these jurisdictions, and especially the United States and the United Kingdom, harbor the biggest and most important financial markets globally. Precisely for this reason, whatever discussions of financial fraud in other, less prominent financial markets do exist in the English language literature are not given much prominence in the present paper. Second, to secure that the literature review has significance for our understanding of financial fraud in contemporary financial markets, only the literature dealing with financial frauds in the last couple of decades is included in the review.
2. Note that the literature review's focus on 'fraudulent behavior in the context of financial market activities' implies that (accounting) frauds in the context of nonfinancial corporations are excluded from the analysis presented in this paper. Corporate (accounting) frauds are dealt with elsewhere in this special issue.
3. Researchers approaching fraud as a behavioral category have proposed many definitions of fraud, ranging from such cursory ones as 'the obtaining of goods and/or money by deception' (Levi, 2009, p. 224) to more elaborate ones that claim fraud is 'a human endeavor, involving deception, purposeful intent, intensity of desire, risk of apprehension, violation of trust, rationalization, and so

- on'. (Ramamoorti and Olsen, 2007). The law is just as ambiguous about the phenomenon. Legal scholars have repeatedly stressed the ambiguity of the legal concept of fraud and have at times even referred to the body of law dealing with fraud as a 'conceptual morass' (Podgor, 1999; Green, 2007).
4. The primary concern of the literature review presented in this paper is with the fraudulent acts, rather than the victims and perpetrator of those acts. Perpetrators and their motivations are discussed insofar as they contribute to our understanding of the reasons for the occurrence of the fraudulent act. However, matters that are related to the phenomenon of financial fraud, but that do not bear direct relevance for the occurrence of the fraudulent acts themselves, such as victims' coping strategies or perpetrators' postfraud rationalizations are not discussed in the present paper.
  5. Arguably, a third objective of false financial disclosures may be the facilitation of other forms of financial crime, such as money laundering operations or the execution of elaborate tax evasion schemes (see Platt, 2015). The role of accounting fraud in the facilitation of these crimes will not be dealt with in this paper.
  6. A look at accounting fraud in more detail reveals that, in carrying out their schemes, perpetrators resort to an enormous variety of fraudulent accounting techniques. A review of the literature (e.g. Mulford and Comiskey, 2002; Jones, 2011; Zack, 2013), however, shows that this myriad of techniques can be broken down into five broad categories. The first two of these, *revenue-based schemes* and *expense-based schemes*, aim at artificially boosting a firm's current profitability as reported on the income statement. The third and fourth categories, *asset-based schemes* and *liability-based schemes*, involve the fraudulent strengthening of the balance sheet through misrepresentations of asset values and risk exposures, in order to increase a company's financial health and perceived future earnings power. The final category, *other financial statement schemes*, represents a residual one.
  7. High-profile rogue trading scandals that erupted in the aftermath of the global financial crisis of 2007–2008 include those of Jerome Kerviel of Société Générale, Kweku Adoboli of UBS and Bruno Iksil, a.k.a. 'the London Whale', of JP Morgan.
  8. Because of its centrality to the recent financial crisis, the vast majority of the literature on mortgage fraud is concerned with the US mortgage market. Mortgage fraud is, however, not unique to the United States. It has been said to be a serious threat as well in countries such as the United Kingdom (Ryder, 2014) and the Netherlands (Van Gestel, 2010).
  9. Note that SAR filings do not reveal the full extent of mortgage fraud. Not only does much fraud go undetected or unreported, institutions that are not federally insured, such as independent mortgage lenders and mortgage brokers, are not required to file SARs (Smith, 2010; Gans, 2011).
  10. According to Barnett (2013, p. 108), the subprime mortgage market grew by 324% from \$190 billion in 2001 to \$615 billion in 2016.
  11. It has been suggested by several observers that one important explanation for the low levels of law enforcement is that, despite warnings by the FBI that mortgage fraud was endemic and that a major crisis was pending, the Bush administration decided to focus attention on the War on Terror. As a consequence, the FBI saw the staffing of its white-collar crime unit reduced by 36% in 2001 (Ferguson, 2012).
  12. As the authors of the study emphasize, these results are complicated by the fact that it is difficult to determine where exactly in the supply chain of credit – be it at the level of the borrower, the lender or the underwriter – the misrepresentation took place. Theoretically at least, it is possible that underwriters were unable to detect misrepresentations that had occurred at the level of the loan origination process, despite their genuine efforts to perform due diligence.
  13. In some cases, what begins as a false financial disclosure may over time evolve into a true financial scam. Entrepreneurs running an otherwise legitimate enterprise may, as their business gets into difficult times, turn to false financial disclosures to paint an artificially rosy picture of the business' profitability and financial health to investors and creditors. In some cases, the necessity of fraudulent disclosures may disappear as time passes and the business becomes profitable again. In other cases,

however, the business continues to falter. Unwilling to admit to failure and declare bankruptcy, some entrepreneurs may then slide further down the ‘slippery slope of fraud’, leading their business to evolve into a true scam.

14. Paper earnings are earnings that are not actually paid out to investors but that accumulate within in the scheme.
15. Stolen financial identities are also used in the perpetration of other types of financial crimes such as money laundering and terrorist financing (Acoca, 2008, p. 77; Ozaki, 2008, pp. 12–14). The use of identity abuses in these kinds of crimes are not discussed in this paper.
16. Because of the fictitious nature of the identity, there are no consumer-victims involved in this type of fraud. The primary victims are the financial service providers that extend the credit lines.
17. Note that legal systems prohibit financial mis-selling practices primarily through the imposition of fiduciary duties and suitability requirements. As no material misstatements of facts are involved in genuine financial mis-selling cases, general fraud laws generally do not apply.
18. In the United States, as well as in most other countries with developed financial markets, regulators employ a two-track regulatory system in which they distinguish between ‘sophisticated’ and ‘nonsophisticated’ or ‘unsophisticated’ investors. Under such a regulatory regime, sophisticated investors (mostly institutional investors and big corporations) are largely exempted from protective regulation, allowing them to engage in tailored contracts that help them to fulfill needs stemming from their specific investment strategies (see Markham, 1995). Unsophisticated investors (mostly retail consumers and small and medium enterprises), are protected against exploitative practices by a relatively paternalistic regulatory regime that relies on legal concepts such as fiduciary standards and suitability requirements.
19. One prominent example of a mis-selling scandal in which the victims were considered sophisticated investors is the Goldman Sachs ABACUS transaction, a \$2 billion synthetic CDO deal that the bank allegedly tricked investors to invest in, even though it knew the deal to be a bad investment. Although the ABACUS transaction represents one of the most compelling occurrences of the mis-selling of structured finance products in the wake of the credit crunch, it is not an isolated case. Similar cases have been mentioned in the literature that involve Deutsche Bank (Scopino, 2014), JP Morgan (Ryder, 2014), Merrill Lynch (Taibbi, 2009) and Citigroup (Ryder, 2014).
20. In fact, many of these ‘independent’ mortgage banks later became subsidiaries of ‘respectable’ banks that operated as securitizers and underwriters in the secondary mortgage market (Rosoff *et al.*, 2014, p. 48).
21. More recently, the issue of mis-sold life insurances has resurfaced in both the United States and the United Kingdom. Driven by presumably faulty and misleading advice, many people in the United States over the last decade have rolled-over from 401(k) pension plans to so-called individual retirement accounts (IRAs), which give more freedom to individuals to make decisions about their own investments. The deceptive sales practices have resulted in regulatory actions by the Department of Labor and FINRA, the financial industry’s self-regulatory authority (Turner and Klein, 2014). In the United Kingdom, a new mis-selling scandal is in the making that involves annuities (FCA, 2015). In many cases, pensioners in poor health have been mis-sold regular annuities while in fact they were entitled to so-called ‘enhanced annuities’, which provide higher payments to compensate for shorter life expectancies (Dyson, 2014; Hyde and Morley, 2014; Morley, 2015).
22. The mis-selling affair in the Netherlands, in the country itself usually referred to as the ‘*woekerpolisaffaire*’, involved not only life insurance policies but also mortgage-related payment-protection insurance policies, study saving plans, and other kinds of investment-related insurance plans.
23. In the Netherlands, the majority of IRHPs that were (mis-)sold to SMEs involved plain vanilla swaps. In Belgium, investigations by the financial market regulator focused on the mis-selling of so-called

- 'Bermudan callable swaps', which had been sold to SMEs during the period 2007 to 2009 (FTM, 2015).
24. In the United Kingdom, the FSA reached an agreement with eight banks that had been involved in the scandal – most notably Barclays, HSBC, Lloyds, and RBS – that forced these banks to provide redress and compensation to customers who had been mis-sold IRHPS. As was the case in the United Kingdom, the Belgian financial market regulator FSMA used its authority to force banks to re-evaluate their most questionable IRHPS sales to SMEs, that is, those that involved so-called 'Bermudan callable swaps', and provide suitable redress to the SMEs (FTM, 2015). The regulator in the Netherlands (the AFM) did not use its authority to force banks to re-evaluate their sales of IRHPS to SMEs but nevertheless said that the advice given by banks to SMEs was often inadequate and urged banks themselves to come up with a suitable solution to the problem (AFM, 2014).
  25. Nevertheless, some SMEs have filed private and collective suits against the banks that sold them the IRHPS, accusing them of misleading marketing and sales practices in regard to these products.
  26. Note that the observation that deregulation has been identified in the literature as a facilitator of financial fraud scandals that have occurred in the past decades is different from saying that deregulation has been a cause of a general increase in the occurrence of financial fraud across the board.

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