

The Typology of Financial Scandals

By Sam Vaknin, Ph.D.

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Tulipmania - this is the name coined for the first pyramid investment scheme in history.

In 1634, tulip bulbs were traded in a special exchange in Amsterdam. People used these bulbs as means of exchange and value store. They traded them and speculated in them. The rare black tulip bulbs were as valuable as a big mansion house. The craze lasted four years and it seemed that it would last forever. But this was not to be.

The bubble burst in 1637. In a matter of a few days, the price of tulip bulbs was slashed by 96%!

This specific pyramid investment scheme was somewhat different from the ones which were to follow it in human financial history elsewhere in the world. It had no "organizing committee", no identifiable group of movers and shakers, which controlled and directed it. Also, no explicit promises were ever made concerning the profits which the investors could expect from participating in the scheme - or even that profits were forthcoming to them.

Since then, pyramid schemes have evolved into intricate psychological ploys.

Modern ones have a few characteristics in common:

First, they involve ever growing numbers of people. They mushroom exponentially into proportions that usually threaten the national economy and the very fabric of society. All of them have grave political and social implications.

Hundreds of thousands of investors (in a population of less than 3.5 million souls) were deeply enmeshed in the 1983 banking crisis in Israel.

This was a classic pyramid scheme: the banks offered their own shares for sale, promising investors that the price of the shares will only go up (sometimes by 2% daily). The banks used depositors' money, their capital, their profits and money that they borrowed abroad to keep this impossible and unhealthy promise. Everyone knew what was going on and everyone was involved.

The Ministers of Finance, the Governors of the Central Bank assisted the banks in these

criminal pursuits. This specific pyramid scheme - arguably, the longest in history - lasted 7 years.

On one day in October 1983, ALL the banks in Israel collapsed. The government faced such civil unrest that it was forced to compensate shareholders through an elaborate share buyback plan which lasted 9 years. The total indirect damage is hard to evaluate, but the direct damage amounted to 6 billion USD.

This specific incident highlights another important attribute of pyramid schemes: investors are promised impossibly high yields, either by way of profits or by way of interest paid. Such yields cannot be derived from the proper investment of the funds - so, the organizers resort to dirty tricks.

They use new money, invested by new investors - to pay off the old investors.

The religion of Islam forbids lenders to charge interest on the credits that they provide. This prohibition is problematic in modern day life and could bring modern finance to a complete halt.

It was against this backdrop, that a few entrepreneurs and religious figures in Egypt and in Pakistan established what they called: "Islamic banks". These banks refrained from either paying interest to depositors - or from charging their clients interest on the loans that they doled out. Instead, they have made their depositors partners in fictitious profits - and have charged their clients for fictitious losses. All would have been well had the Islamic banks stuck to healthier business practices.

But they offer impossibly high "profits" and ended the way every pyramid ends: they collapsed and dragged economies and political establishments with them.

The latest example of the price paid by whole nations due to failed pyramid schemes is, of course, Albania 1997. One third of the population was heavily involved in a series of heavily leveraged investment plans which collapsed almost simultaneously. Inept political and financial crisis management led Albania to the verge of disintegration into civil war.

But why must pyramid schemes fail? Why can't they continue forever, riding on the back of new money and keeping every investor happy, new and old?

The reason is that the number of new investors - and, therefore, the amount of new money available to the pyramid's organizers - is limited. There are just so many risk takers. The day of judgement is heralded by an ominous mismatch between overblown obligations and the trickling down of new money. When there is no more money available to pay off the old investors, panic ensues. Everyone wants to draw money at the same time. This, evidently, is never possible - some of the money is usually invested in real estate or was provided as a loan. Even the most stable and healthiest financial institutions never put aside more than 10% of the money deposited with them.

Thus, pyramids are doomed to collapse.

But, then, most of the investors in pyramids know that pyramids are scams, not schemes. They stand warned by the collapse of other pyramid schemes, sometimes in the same place and at the same time. Still, they are attracted again and again as butterflies are to the fire and with the same results.

The reason is as old as human psychology: greed, avarice. The organizers promise the investors two things: that they could draw their money anytime that they want to and that in the meantime, they will be able to continue to receive high returns on their money.

People know that this is highly improbable and that the likelihood that they will lose all or part of their money grows with time. But they convince themselves that the high profits or interest payments that they will be able to collect before the pyramid collapses - will more than amply compensate them for the loss of their money. Some of them, hope to succeed in drawing the money before the imminent collapse, based on "warning signs". In other words, the investors believe that they can outwit the organizers of the pyramid. The investors collaborate with the organizers on the psychological level: cheater and deceiver engage in a delicate ballet leading to their mutual downfall.

This is undeniably the most dangerous of all types of financial scandals. It insidiously pervades the very fabric of human interactions. It distorts economic decisions and it ends in misery on a national scale. It is the scourge of societies in transition.

The second type of financial scandals is normally connected to the laundering of capital generated in the "black economy", namely: the income not reported to the tax authorities. Such money passes through banking channels, changes ownership a few times, so that its track is covered and the identities of the owners of the money are concealed. Money generated by drug dealings, illicit arm trade and the less exotic form of tax evasion is thus "laundered".

The financial institutions which participate in laundering operations, maintain double accounting books. One book is for the purposes of the official authorities. Those agencies and authorities that deal with taxation, bank supervision, deposit insurance and financial liquidity are given access to this set of "engineered" books. The true record is kept hidden in another set of books. These accounts reflect the real situation of the financial institution: who deposited how much, when and under which conditions - and who borrowed what, when and under which conditions.

This double standard blurs the true situation of the institution to the point of no return. Even the owners of the institution begin to lose track of its activities and misapprehend its real standing.

Is it stable? Is it liquid? Is the asset portfolio diversified enough? No one knows. The fog enshrouds even those who created it in the first place. No proper financial control and audit is possible under such circumstances.

Less scrupulous members of the management and the staff of such financial bodies usually take advantage of the situation. Embezzlements are very widespread, abuse of authority, misuse or misplacement of funds. Where no light shines, a lot of creepy

creatures tend to develop.

The most famous - and biggest - financial scandal of this type in human history was the collapse of the Bank for Credit and Commerce International LTD. (BCCI) in London in 1991. For almost a decade, the management and employees of this shady bank engaged in stealing and misappropriating 10 billion (!!!) USD. The supervision department of the Bank of England, under whose scrutinizing eyes this bank was supposed to have been - was proven to be impotent and incompetent. The owners of the bank - some Arab Sheikhs - had to invest billions of dollars in compensating its depositors.

The combination of black money, shoddy financial controls, shady bank accounts and shredded documents proves to be quite elusive. It is impossible to evaluate the total damage in such cases.

The third type is the most elusive, the hardest to discover. It is very common and scandal may erupt - or never occur, depending on chance, cash flows and the intellects of those involved.

Financial institutions are subject to political pressures, forcing them to give credits to the unworthy - or to forgo diversification (to give too much credit to a single borrower). Only lately in South Korea, such politically motivated loans were discovered to have been given to the failing Hanbo conglomerate by virtually every bank in the country. The same may safely be said about banks in Japan and almost everywhere else. Very few banks would dare to refuse the Finance Minister's cronies, for instance.

Some banks would subject the review of credit applications to social considerations. They would lend to certain sectors of the economy, regardless of their financial viability. They would lend to the needy, to the affluent, to urban renewal programs, to small businesses - and all in the name of social causes which, however justified - cannot justify giving loans.

This is a private case in a more widespread phenomenon: the assets (=loan portfolios) of many a financial institution are not diversified enough. Their loans are concentrated in a single sector of the economy (agriculture, industry, construction), in a given country, or geographical region. Such exposure is detrimental to the financial health of the lending institution. Economic trends tend to develop in unison in the same sector, country, or region. When real estate in the West Coast of the USA plummets - it does so indiscriminately. A bank whose total portfolio is composed of mortgages to West Coast Realtors, would be demolished.

In 1982, Mexico defaulted on the interest payments of its international debts. Its arrears grew enormously and threatened the stability of the entire Western financial system. USA banks - which were the most exposed to the Latin American debt crisis - had to foot the bulk of the bill which amounted to tens of billions of USD. They had almost all their capital tied up in loans to Latin American countries. Financial institutions bow to fads and fashions. They are amenable to "lending trends" and display a herd-like mentality. They tend to concentrate their assets where they believe that they could get the highest yields in the shortest possible periods of time. In this sense, they are not

very different from investors in pyramid investment schemes.

Financial mismanagement can also be the result of lax or flawed financial controls. The internal audit department in every financing institution - and the external audit exercised by the appropriate supervision authorities are responsible to counter the natural human propensity for gambling. They must help the financial organization re-orient itself in accordance with objective and objectively analysed data. If they fail to do this - the financial institution would tend to behave like a ship without navigation tools. Financial audit regulations (the most famous of which are the American FASBs) trail way behind the development of the modern financial marketplace. Still, their judicious and careful implementation could be of invaluable assistance in steering away from financial scandals.

Taking human psychology into account - coupled with the complexity of the modern world of finances - it is nothing less than a miracle that financial scandals are as few and far between as they are.

Sam Vaknin is the author of "Malignant Self Love - Narcissism Revisited" and "After the Rain - How the West Lost the East". He is a columnist in "Central Europe Review", United Press International (UPI) and ebookweb.org and the editor of mental health and Central East Europe categories in The Open Directory, Suite101 and searcheurope.com. Until recently, he served as the Economic Advisor to the Government of Macedonia.

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Personal Finance Worries?

By John Q. Miller

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Are you nervous about your personal finances? The irrational exuberance of the 90s that led to double-digit gains for almost any investment portfolio is over. Now, you might consider yourself fortunate if your investments are losing less than the S&P 500. Add investment worry to the regular personal finance worries of meeting your monthly budget, slaying the debt dragon, and starting/building that elusive emergency fund. Will your savings and investments be able to meet your retirement, children's college funds, and other goals? Although no one can see the future, there are things that you can do to reduce your worries.

Knowledge Is Power

Learn and become more skilled in financial matters. The best way to improve your financial education is to read personal-finance magazines, books, and even newspapers. The educational materials sent out by mutual-fund companies and brokerages are also valuable. You may come across conflicting information and advice, but if you read widely, you will eventually get a better idea of how to manage your money.

Do-it-yourselfers are not the only people who can benefit from learning more. If you use a financial planner and yet are knowledgeable about investments, insurance, etc., you are more likely to end up with a solid financial plan. If you find yourself teamed up with an inadequate or unethical adviser, and you have a good understanding of investing, you are more likely to recognize bad advice.

Fear Creates Worry

"Greed is good!" says Gordon Gecko (Michael Douglas) in Wall Street. Recent investment losses, corporate scandals, and a stagnant economy refute that statement. Instead, a warning is emerging in personal finance forums as we search and hope for indications that relief is in sight. Fear is bad! Fear has driven many investors either to dump stocks and load up on bonds, certificates of deposit and other conservative investments or, even worse, to stop saving and investing. This creates new problems. People will be incapable of achieving their long-term financial goals because their portfolio may now be so conservative that it won't deliver the returns needed to retire in comfort, or they are simply saving too little.

Faced with this fear and uncertainty, financial knowledge is more important than ever. Instead of reacting to the market's ups and downs, learn more about the characteristics of stocks, bonds, and other investments; as well as the broad array of personal finance and money management topics.

About The Author

This review is courtesy of John Q. Miller at <http://www.MoneyLighthouse.com> where you can find personal finance information to help you navigate through the fog of money management. You may purchase personal finance books from the site at an incredible discount too!

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