To what extent was the Wall Street subprime mortgage lending crisis the primary cause for ending Bernie Madoff's Ponzi Scheme in 2008?

Word Count: 2189

Section A: Identification and Evaluation of Sources

The task of this investigation is to analyze the question: To what extent was the subprime mortgage lending crisis of 2008 the primary cause for ending Bernie Madoff's Ponzi scheme? The U.S Securities and Exchange Commission's report on the *Investigation of failure of the SEC to uncover Bernard Madoff's Ponzi Scheme* is relevant because it explores the reasoning behind the factors that helped sustain Madoff's Ponzi scheme, therefore contextualizing factors that impact such a scheme's longevity. Economist Edward Stringham's *It's not me, it's you: the functioning of Wall Street during the 2008 economic downturn,* provides a perspective that investigates how the public's poor decision making led to the closure of investment firms, similar to Madoff's. Together, the sources compare and contrast the possibilities of causation.

United States Securities and Exchange Commission. "Investigation of failure of the SEC to uncover Bernard Madoff's Ponzi Scheme." 2009.

The origin of this publication is that it was submitted in 2009, one year after Madoff was caught, by Harold David Kotz, the Inspector General of the U.S. Securities and Exchange Commission. The value is that it contains multiple perspectives of SEC members that worked on Madoff's case, therefore increasing credibility. The limitation of this perspective comes from the bias towards blaming themselves as it is their job is to take accountability for unnoticed fraudulent activity.

The purpose of this publication was to demonstrate that the SEC recognizes the errors they made during their investigation. The value of this publication is that it was created to acknowledge the factors that impacted Madoff's scheme, therefore, analyzing what sustained it. The limitation is that they disregard exterior aspects that could have had an impact on the downfall of the scheme as they exclusively outline their mistakes.

The content of this publication consists of findings from various SEC members that were involved in the Madoff case and their analysis of where they overlooked the investigation. The value is that it provides a compilation of primary sources that share what they witnessed during the events that transpired. The limitation of the content is that this report does not outline why Madoff surrendered himself which would have elevated the understanding of how their actions directly impacted the case.

Stringham, Edward, "It's not me, it's you: the functioning of Wall Street during the 2008 economic downturn." *Public Choice,* vol. 161, no. 3, 2014, pp. 269-288, JSTOR, https://www.jstor.org/stable/24507494

The origin of this journal is that it was written by Edward Stringham in 2014, who was an economist during the Great Recession and is now the president of the American Institute for Economic Research. The value of the origin is that he provides studies of how people acted in economic settings before and after the crisis, demonstrating analysis of whether such a liquidity lock caused panic amongst people. The limitation of the origin is that he carries limited knowledge on issues that investment firms may face when such a crisis is in effect.

The purpose of this journal was to advance his claim that the ill-advised decisions made by the people are the primary cause of the recession. The value of the purpose is that it provides a perspective that blames civilians as possible causes for aspects of the recession, therefore holding the people responsible for the effects of the recession, such as the fall of investment firms like Madoff's. The limitation of the purpose is that Stringham created this argument to demonstrate who is to blame for the recession, rather than arguing what the disputable effects of the recession were.

The content of this journal addresses differences between problems with individuals and problems with the market itself as causes for the Great Recession. The value of the content is that it provides a compilation of evidence and analysis that highlights the knowledge of the general public, which impacts how they react to locks on liquidity. The limitation of this content is that it provides arguments that generalize the recession’s effects, therefore not going in-depth on specified failures.

Section B: Investigation

Bernie Madoff ran the largest Ponzi scheme in history which came to an end in 2008. Before 2008, a series of loans were offered by banks at subprime, which involves loaning money to people with low credit scores in return for high-interest rates. This sparked the subprime mortgage lending crisis, known as the Great Recession. During this recession, Bernie Madoff was convicted on counts of fraud for running a Ponzi scheme through an investment firm that is accredited to have stolen billions of dollars. A Ponzi scheme is where a proclaimed investment firm uses the money that they are given from new investors to pay back the promised returns to older investors, therefore, these investment firms can promise unrealistic return rates to attract more clients. When analyzing the downfall of this scheme, uncertainty exists due to the lack of consensus amongst theories behind the cause of the downfall as this event occurred in 2008, not giving historians enough time to reach consensus. Bernie Madoff's Ponzi scheme came to an end due to his confessions to family members, however, the subprime mortgage lending crisis of 2008 primarily forced the cessation of Bernie Madoff’s Ponzi scheme to an extent where it caused a liquidity lock in banks, therefore encouraging the public to demand their money back, making a Ponzi scheme unfeasible.

The SEC is intended to be the organization that uncovers fraudulent investor activity; however, they were insignificant in the demise of Madoff’s scheme. According to Peter Lamore, who conducted the 2005 examination of Madoff, stated that if the SEC was able to contact counterparties, they would have uncovered the scheme before the confession (U.S. SEC 363). However, John Walsh, Acting Director of the Office of Compliance Inspections and Examinations, admits that third-party verification was not required for their routine (U.S. Committee on Banking, Housing, and Urban Affairs 35). The lack of utilizing third-party verification showcases the SEC's shortcomings. The flaws in the SEC's procedure helped Madoff's track record be perceived as clean, including the investment firm that Madoff dealt with, reinstating the idea that the SEC did not play a significant role in ending the scheme. Andrew Cooperman, an investment adviser who studied the actions of Madoff's accountants, Frank Avellino and Michael Bienes, stated in a brochure that in over 20 years of Avellino and Bienes' history, there has never been a losing transaction (U.S. SEC 43). The absence of a losing transaction creates a lack of suspicion from the SEC, making this case seem unimportant. The SEC investigation on Madoff was stalled due to needed focus on a mutual fund issue (U.S. SEC 125). The SEC placed the investigation on halt as Madoff's actions were not unusual, depicting that Madoff hid his fraudulent acts well. The SEC's shortcomings contributed to the sustainability of Madoff's scheme.

Although Madoff ultimately confessed to the scheme, the subprime mortgage lending crisis created an environment that was unsuitable for a Ponzi scheme to be sustained. Edward Stringham, President of the American Institute for Economic Research, claims that the general public had the ability to purchase private protections against fraud before the crisis was in full effect (Stringham 270). Stringham's reassurance that the poor decisions made by the people were the primary cause of the crisis helps the argument that the crisis caused the fall of Madoff's scheme. The SEC had little effect in uncovering the case; instead, it was the people's realization of their actions that encouraged them to liquidate their money out of possibly fraudulent firms. Eric S. Rosengren, president of the Federal Reserve Bank of Boston, stated that the situation was a liquidity lock, negatively impacting short-term financing and slowing down the process to obtain loans (Kliman 34). A liquidity lock evokes panic from society as people demand their cashback from investment firms due to distrust. The panic caused by the liquidity lock had a large impact on investment firms, especially Ponzi schemes, as they cannot sustain the demand. The Home Mortgage Disclosure Act defines a high-cost loan if cost information shows that the average percentage rate is higher than the US treasury rate (Moulton 95). As of 2007, subprime mortgage loans and foreclosure rates increased by 15.6% (Smith 65). According to economist Andrew Kliman, the people who were dealt these mortgages at subprime had to pay for this with income but instead paid for them with more debt (Kliman 31). This created the realization that these subprime loans were unsustainable. An abundance of loans offered at subprime is what led to a lock on withdrawable cash, as debt was being paid off in assets. Banks had assets they could not liquidate fast enough to fulfill the requests of people wanting their money back. From a political standpoint, the cause of this crisis was an abundance of greed as banks were chasing after the possibility of receiving a high-interest rate (Stringham 270). The perception that the banks were greedy created general distrust in society, encouraging people to liquidate their assets, a task that was not feasible for Madoff’s firm as a Ponzi scheme relies on the idea of using one’s investments to pay for another one’s returns. This reassures that society was concerned with the uncertainty of their money being repaid, leading to panic as people felt they did not have access to their money.

Typically, one's attempt to sustain an act of fraud in the U.S. would be suppressed through law enforcement, however, Madoff's ability to hide such acts, rendered regulations ineffective. The Lehman Brother closing made demand increase for more transparency (Becchetti 40). However, Madoff's firms met regulatory deadlines as well as reporting obligations (Heydenburg 29). Meeting regulatory deadlines is an indicator to law enforcement that one's record is clean; proving the point that they were wrong in this scenario as Madoff was far from clean. According to Madoff, whenever he met with the SEC and commented how the industry is overregulated, they would not pay attention to his complaint (Lewis 186). Madoff argued for leeway despite not being investigated for the fraudulent acts he was committing, representing an under-regulated industry rather than an overregulated one. Madoff stated in his roundtable discussion, that it was virtually impossible to violate rules during the modern regulatory environment (Lewis 187). This would make it seem as if Madoff is not violating any laws to prove the legitimacy of his actions. He earned this legitimacy by maintaining records that could not possibly indict him for fraud before the confession.

Bernie Madoff's long-lasting Ponzi scheme was primarily forced to come to an end as the effects of the 2008 subprime mortgage lending crisis were too overwhelming to sustain such a scheme. Although the SEC is accredited for sustaining the fairness of investing, they are ruled out as a factor for uncovering the case as their mishaps are what contributed to the longevity of the scheme. Additionally, Madoff's actions were overlooked by law enforcement as he was perceived as unsuspicious. The subprime mortgage lending crisis had an indirect effect on Madoff's scheme that evoked a sense of panic as numerous amounts of people demanded their money back, a situation that collapses the sustainability of a Ponzi scheme.

Section C: Refection

This investigation allowed me to compare and contrast the possibilities that could have been the primary cause of an event. I was faced with distinguishing a report that assessed that the recession was worsened internally, from an opinionated journal that possessed claims that held the general public responsible for the negative effects of the recession. One challenge I faced during this process was the lack of consensus between historians on the matter of the causes and effects of the Great Recession.

The lack of consensus amongst experts is something that historians struggle with. I had trouble with interpreting the numerous theories available, as the reasoning behind why Madoff was motivated to end his scheme is not agreed upon. Historians' lack of consensus can cause stalemate when trying to conduct a historical investigation. I realize historians, such as Stringham, must rely on an element of trust when comparing and contrasting the credibility of sources as they are secondary sources that did not witness the event unlike members of the SEC.

The method of causation posed a challenge in this scenario. Causation in this is the focal point of this investigation. I specifically was challenged with the idea of whether using intuition to connect two events was not credible enough for this investigation. My challenges grew as there was no consensus on what motivated Madoff to end his long-lasting Ponzi scheme. Therefore, I had to breakdown why a Ponzi scheme would not be feasible in the economic environment where it had ended, which happened to be the 2008 subprime mortgage lending crisis.

Causation challenges historians because the documentation of all the events that have transpired is far from achieved. Therefore, a historian cannot assert a claim regarding causation without having uncertainty that an event is perceived as unrelated could be related. In this case, the reality of events is that Madoff confessed to running a Ponzi scheme during a national recession. Using intuition, I am inclined to believe that Madoff's confession to financial fraud during an economic crisis, is related. However, the reality of those events could be coincidental as Madoff may have had other motivations to end his scheme. Historians struggle with the concept that the convenience of evidence might lead to a premature conclusion, influencing how people perceive the causation of events.

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