PERSONAL FINANCE

Bernard Madoff Is The Fraud Triangle

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The Fraud Triangle is a model developed by Dr. Donald Cressey, a criminologist whose research focused on fraudsters. According to Dr. Cressey, there were three factors that were present when an ***ordinary*** person committed fraud:

Image via Wikipedia

- Pressure
- Opportunity
- Rationalization

I think few would say that Bernard Madoff was an "ordinary" person but his fraud can be dissected into the components of the Fraud Triangle.

The New York Magazine's Steve Fishman conducted a series of phone interviews with Bernard Madoff, who seems to be talking as much as Charlie Sheen these days, about his crime and what he has to say for himself about his actions. It is a fascinating read.

Pressure (Panic Redemptions of the 1987 Crash) – In the eighties Madoff said he saw consistent returns of 15%-20%….a time when the DJIA went from 800 to 2,722 from 1980 to its peak before the crash of 1987 (a growth rate of about 15% compounded a year). So Madoff could have invested in an index fund and done as well as anyone. But the sell-off associated with the crash (redemptions) and the slow recovery (low returns) put pressure on Madoff. That's when Madoff borrowed from investor capital to pay out redeeming investors and began falsifying results showing big returns. Those returns became the advertising he needed to get more investors/victims.

Opportunity (Nobody Asked Questions) – Many large investment banks like UBS, Credit Suisse and Banco Santander saw Madoff's returns and wanted to invest. However, Madoff refused to disclose the means by which he was maintaining his consistent returns. The banks, according the Madoff, never pushed further for more information beyond the false return statements that they had received. In reality, Madoff was taking the money, sticking it in treasuries yielding 2% and started printing false statements showing holdings in stocks yielding far more. Funding from sophisticated investors began to flow to Madoff.

Rationalization (Everyone was greedy) – From the beginning, Madoff seemed doomed to make a mistake thinking that Wall Street was rigged against the little guy. Thoughts of "getting even" seemed to be deeply rooted in his initial view of the financial market. Madoff said he put up warning signs to potential investors who pursued him to invest their money. The warnings, that investing is risky and could lead to losses, were enough of a disclosure to get permission to take more money into the scheme.

While Madoff's despicable act is not to be debated, a look at the Opportunity portion of the fraud triangle provides us a glimpse at where the SEC and professional investment institutions could have done more to catch Madoff earlier. Most of us are not interested in what mad thoughts drove Madoff to steal or justify the theft, but what could have been done to prevent it.

Trying to understand the rationalization or pressure Madoff faced to justify his actions will be debated for years but those answer are sure to only spark more questions. An upcoming book on Madoff, ***Wizard of Lies***, by Diana Henriques should be a more in-depth look at Madoff based on her interview with Madoff in federal prison. When I asked Diana if Madoff ever turned away any investors, she told me "he did turn down money if the investor was too nosy." Perhaps that's the best lesson we can learn from Madoff's crime.

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