Leeds University Business School - Research and Innovation Podcast

Episode: 300 years of deceit: a systemic look at financial crime in the UK

Speakers: Addi Manolopoulou and Professor Steve Toms

[00:00:05] **Addi:** Hello and welcome to the Research and Innovation Podcast. My name is Addi Manolopoulou, and I am the accounting and finance department manager here at Leeds University Business School.

Today, I am delighted to be joined by Professor Steve Toms, a brilliant mind in accounting and finance, and the author of a compelling new book titled “Systems of Deceit”. We will be diving into the dark, complex world of finance crime, and let's think of it as the Netflix thriller you didn't know was hiding in your finance textbook.

Steve, welcome, and first of all, congratulations on “Systems of Deceit”. The title is evocative, to say the least. What made you choose it?

[00:00:48] **Steve:** Thank you for that introduction. Yeah, I wanted to write a book about fraud; I teach fraud to our students. It's an area of, I think, fascinating research and obviously it's a big problem in today's economy.

So what I wanted to do was write a book about financial crime in the United Kingdom, but not necessarily to look at the motivations of the individuals involved with it, but to look at its systematic determinants. So hence the title “Systems of Deceit”. So what it does really, it takes the view that there are always gonna, in any given society, there're always going to be certain individuals who want to commit fraud if the opportunity presents itself.

So the thing that I think varies actually is the opportunity itself, and that's a function of the kinds of economic institutions of regulation and of legal oversights that persist in any given economy at any given point in time. And not just that also, which sectors are the dominant ones? So, for example, do you have a dominant finance sector? Do you have a dominant, manufacturing sector? Does the government play a large role in economic activity? Things like that. Which I think do impact on the balance of opportunity for the potential fraudster.

So what the book does, is it provides the context really, you know, given that fraud is a big problem nowadays - what does it look like if we compare it to previous, these previous configurations and balances in the economy of regulation, sectoral balances, and so on.

So, what it does is not only look at, or contextualize fraud in today's society, but it also essentially is a history book looking at 300 years of financial crime.

[00:02:40] **Addi:** You know, with a title like that, Steve, I was half expecting you to have written a political thriller, but I do love how you're tackling a real-world issue with such depth. It's not just about the “who”, it's about the “why” and the “how”, and that's where it gets really juicy. So tell us more about the research. What kind of data did you wrangle for this?

[00:03:02] **Steve:** Okay, so the research is really based on types of sources. First of all, it's a pioneering book in the sense that its methodologies, utilizes searchable newspaper archives. And we've only been able to do this really for a few years, you know, with the advances in technology and the archiving of significant sources of, or significant numbers of old newspapers. And to have them keyword searchable is a fantastic tool for the researchers. So that's the first thing it exploits.

And it covers a period of 300 years from 1700 to 2010. So the bookends for this really the one end, the South Sea bubble, a famous early scandal that engulfed the economy back in 1720. And then in more, more recent memory of the global financial crisis and its immediate aftermath. So that's the first source of data.

Secondly, what I've done is assembled a database of 30, or slightly over actually - 300 plus corporate financial scandals which are categorized in the database according to things like the sector in which the company was operating, some features of its organizational structure, the economic sector it was in, and any international dimensions to the scandal that might be significant. So, putting those two things together has allowed me to take a long run view, identifying periods when we've had a lot of fraud and a lot of corporate financial scandal because the two things, the two data sets are actually very strongly correlated.

Perhaps not surprising. So we can look at periods when fraud's actually surged, when we've had peaks, and other times when it's been much less problematic. So the key lessons are what are the key lessons we can learn then from contrasting these periods.

[00:05:04] **Addi:** 300 years is some serious historical sleuthing. Honestly, it makes me feel like my Excel spreadsheets have been letting me down. And as about the 300 scandals, were there any that actually didn't make the cut, Steve?

[00:05:19] **Steve:** I tried to make it as comprehensive as possible. Obviously, I'd need to rule out scandals that are of a non-financial nature. So of course, scandals do grab the headlines. You know, things like the perfumer scandal would be an example of that. But, I wouldn't describe it in any direct sense as a financial scandal.

[00:05:39] **Addi:** Hmm. What did the data reveal? What patterns did you start to see?

[00:05:45] **Steve:** Okay. So, if we look at the long run, if we look at the overall picture we've really had two peaks fraud and financial scandal.

That's one in the middle of the 19th century. And one more recently, really, that's evolved since the 1970s. Both of these peaks, what do they have in common? Well, they're strongly associated with financial deregulation. So the 19th century peak was a period of laissez faire. The ideology that said the government doesn't interfere in anything that private business is doing. And to some extent that's been replicated through the neoliberal reforms that have occurred really since the 1980s. So it seems perhaps, hardly surprising that if you deregulate markets, you end up with greater opportunities for fraud, and that seems to be exactly what's happened.

So those are the peaks. What about the kind of low levels? There was a period just after the Second World War that lasted for about 25 years. So roughly 1945 through to 1970. Certainly this was a time really when the opposite happened, the economy was highly regulated. The government intervened significantly.

The financial sector was highly constrained, subjected to significant controls. It was a time when banks were restricted heavily in their lending. So the term “boring banking” was conceived at this time, exactly the opposite of all the crazy trading that was going on, immediately before the global financial crisis.

So it was a time when banking was really quite limited. Banking and finance staff were not particularly highly paid relative to what they paid now. It was very difficult to move money internationally. There were strong restrictions on capital mobility.

You could move money if it went with goods. Or services, but otherwise you couldn't do that. And also there was strongly empowered managerial and professional class, which meant there were hierarchical organizations. Auditing was a prestigious profession. And that meant that there was there were greater structures of accountability.

So I think a combination of all of those factors really explained why we got to fairly low levels during that period. And really, if you look at post 1970, you can see really all of those things turning into their opposites. So financial deregulation, international financial liberalization, free movement of capital, the growth of international secrecy jurisdictions or tax havens, as they're sometimes referred to us. And the general expansion of the banking and finance sector and reduced banking stability. Banks are being encouraged to lend, to make more risky loans.

And that's, generally regarded as being an expansionist economic policy. So I can see the reasons for doing it, but as far as fraud's concerned this is why I think there is a correlation because the systematic problem with risky bank lending is that, credit will be made available, by definition, for more risky projects.

Now again, by definition of following the logic through, more risky, a group of more risky projects means there are likely to be more failures within that group. So when the failures come into financial pressure, to continue to report positive returns to their investors, this is when people start to manipulate the accounts. This is when we start to get the coverup motive for financial and market manipulation.

So I think that gives us a systematic explanation fraud, which should be correlated to the economic cycle. And indeed, that's what we actually find that in looking at the data, those two things are strongly correlated.

And increasingly, the other thing to bear in mind is that financial fraud is actually very strongly associated with the banking and finance sector. So the more the more you expand that sector at the expense of, say, the government or manufacturing, the more likely it is that fraud opportunity rises and, many of these, many of the modern frauds increasingly exploit complex organizational structures and the ability to move money internationally.

If you can move your money down a rabbit hole in the Cayman Islands obviously that makes it very difficult for regulators. It's a big challenge to the audit profession as well.

So these, in these features of the international economy contrast totally, really, with the features of the 1950s and the 1960s, when unsurprisingly, we had much lower levels of fraud.

[00:10:26] **Addi:** Mm. It's essentially like the financial system says “freedom”, and what fraudsters hear is “opportunity knocks”.

[00:10:33] **Steve:** That's a perfect summary. Yes.

[00:10:35] **Addi:** Mm. So who's this book for Steve? Who should have this on their bedside table?

[00:10:40] **Steve:** It isn't exactly bedtime reading. There are quite a few nice graphs; there's a lot of charts and graphs in it. Not so many, not so many pictures, not too many anecdotes. It is quite a serious book on a serious subject, but I do think there is an appeal to the general reader.

It does give a different perspective on fraud and financial scandal to some of the other titles that have been published on the same subject, which tend to look at, you know, scandals as stories. So, you know, fair play to those books. They are probably a bit more readable for that reason, for the general reader. I think it is a book I would recommend to accounting and finance students, particularly those specializing on forensic modules, forensic accounting and finance modules.

But we should bear in mind it's a history book as well. So economic and business historians will find the book interesting. It gives a different perspective on the evolution of British capitalism over 300 years. Telling it from the dark side, so to speak. And I think, finally, it would be of interest to policy makers and regulators, you know?

If you want to, if you want to make good policy, you need to learn from the mistakes of the past. And so I think it would be of interest for that reason.

[00:12:00] **Addi:** Mm. So basically, if you've ever tried to understand a financial scandal and thought, hold on, how do they get away with that? This book's for you, but it's also a great book if you're attending a dinner party with economists and want to sound both smart and just slightly ominous.

[00:12:16] **Steve:** Mm-hmm. Yeah. Yeah.

[00:12:17] **Addi:** But let's talk policy. You touched on that. What can, or should, policy makers be doing?

[00:12:24] **Steve:** Well, it's very interesting. The incoming government have said, you know, we want to tackle fraud. We want to clamp down on it. But at the same time, their other policy announcements are pulling in exactly the opposite direction.

So they want to deregulate and they want to use that deregulation to drive the growth agenda. So I think it's very likely that if they go ahead with this, that fraud is actually going to rise rather than fall. Obviously we'll see what happens, but I would strongly predict that on the basis of the evidence in the book.

So the key question I think for policy makers is how can you achieve a balance? How can you get the benefits of economic growth, but without creating a free-for-all of opportunities for the fraudster? So I think I, some of the key lessons are to have a right, what I call a right-sized financial sector.

That is a financial sector that supports the rest of the economy. It provides credit into it, but it does so on a fairly stable basis. And you're not just expanding this finance sector, just for the sake of it. I mean, through a whole number of other policy reasons for not doing that, you know, such as the North/South divide that we have in our economy, which again, potentially is a big problem. So the idea of the banking sector in the City of London, serving the rest of the economy, is really a lesson from that hiatus period of the 1950s and 1960s. And anything that promotes banking stability, you know, such as restrictions on bank lending through what we now call quantitative tightening - that is forcing banks, for example, to hold government bonds on their balance sheets - restrict movements of capital internationally. I mean that might sound a bit harsh because obviously the free movement of the capital around the globe, is essential to the functioning of the modern economy.

But why on earth do we tolerate tax havens? You know, it just seems to me to be giving everything away to the fraudster. It's a crucial weapon in their armoury nowadays, and to me, that should be the top of the agenda for any government sorting out secrecy jurisdictions.

If you think about it from a UK policy perspective, there are about probably more than 10 secrecy jurisdictions that they have direct control over as crime dependencies or other satellite-type legal jurisdictions. And they could rein these places in, at relatively low cost. But I think with a big benefit in terms of tackling fraud.

Finally, I'll just make a point about policy direction in terms of encouraging entrepreneurship within the economy. Encouraging innovation in developing new products and services, but not financial innovation. Financial innovation is more like “let's devise a way to get around this regulation. Let's try and undermine the regulatory structure”. So, I think you need to look at the type of innovation that your policies are trying to encourage.

[00:15:27] **Addi:** So did I understand this correctly? Is it like, are you saying “less casino capitalism, more old school innovation”, like inventing a product, not a tax loophole?

[00:15:39] **Steve:** Yeah, that's exactly it. Yes. That’s a fair summary.

[00:15:43] **Addi:** Very interesting theory. Okay, Steve, what's next for your research?

[00:15:48] **Steve:** Well, I'm currently working on some new data sets. I want to look at some, a kind of parallel project looking at the evolution of different types of crime.

So some crimes were more prevalent in the past perhaps than they are now. Embezzlement would be an example of that. Accounting manipulation seems to be something that runs right through, you know, you get it pretty much whenever you have a corporate sector with limited joint stock companies, you get accounting manipulation.

You also seem to get all sorts of forms of manipulating financial markets. But there are some more recent financial crimes that have come along. Things like money laundering. Bribery and corruption seem to be much more of a problem now than they have been for a long time. And, of course, cybercrime, I think connected to the development of technology and the internet.

So there are all these different financial crimes and I think they all kind of have their own story to tell about why they become more prevalent in some periods than in others. So I'm currently working on that. I'm scoping out the project. Where it'll go from here, I'm not entirely sure. Partly because I'm still exploring new data sets. I'm looking at, for example, online databases of government documents to see whether it's possible to investigate further the bribery and corruption angle over time. So, things like that. We'll see where it goes.

[00:17:16] **Addi:** That's amazing. You're like the David Attenborough of Financial Times, Steve - documenting the ecosystem, spotting the predators, showing us how they evolved only with fewer penguins, of course, and more offshore accounts.

Steve, thank you so much for joining us. Yeah. "Systems of Deceit" isn't just an impressive piece of scholarship. It seems to me that it's an essential guide to understanding why financial fraud persists and what we can do about it.

To our listeners, whether you're an aspiring forensic accountant, a policy maker, or just a true crime fan with a passion for spreadsheets, this book deserves a spot on your shelf.

Thanks for tuning in, and we'll see you next time on the Research and Innovation Podcast.

Ends