

Policy Design and the Problem of Fraud
"Some Preliminary Ideas from considering Fraud as a Systemic Issue"

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Abstract

This paper seeks to develop an evaluative framework for further consideration of policy design for government and business concerning the problem of serious economic fraud. Considering a recent UK pensions industry scandal and proposals for reform as an example, it is argued that fraud effects the integrity of financial markets and the economic well being of society.

It draws out of Traditional System Dynamics, Senge's Systems Thinking and Soft System Methodology an approach that links real world problems and systemic thinking in order to produce realistic policy initiatives.

The paper sets systemic thinking towards just outcomes in the context of legal, economic and political constraints, the eventual aim being to develop acceptable fraud prevention and detection policies at national and business levels. This work is at a preliminary stage and is attempting to take account of both logic based and wider socio legal analysis.

Introduction

This paper provides a framework for the application of systems thinking to policy design directed towards the problem of fraud. The work attempts to balance policy initiatives and organizational design within political, legal and economic constraints set to achieve just outcomes. Fraud is viewed as a law and policy issue of concern to government and business. It is argued that an understanding of dynamic complexity (Senge 1990) both in terms of the commission of serious economic fraud within and across organizational boundaries and legal responses to it will assist in giving new insights into what might be done.

A fundamental dynamic of the relationship between government and business is the control of the latter by legal regulation which has spawned a mass of literature on compliance and law enforcement (Braithwaite 1992). The effectiveness and cost of these measures are controversial subjects. This paper looks at the counter intuitive effects of such strategies and then steps back to consider how a better understanding of the way fraud is perpetrated across regulatory, business, professional and financial boundaries can improve the likelihood of business controlling the problem and may at least forestall and perhaps avoid altogether the need to have recourse to legal regulation.

Particular focus is placed on how to avoid the development by the United Kingdom government of further regulatory control, draconian anti fraud strategies and criminal sanctions which impose substantial obligations on business which may effect competitiveness and profitability. Drawing from the UK's recent legislation on fraud and proposals for reform in the British Pensions Industry (Goode Report 1993) as examples it is argued that a better understanding of the process of fraud and the counter intuitive effects of business regulation could help avoid further government intervention.

In order to do so business strategic planning must take into account a wider perception of fraud including an acceptance that more can be done within companies to increase awareness of the danger of it and to improve their prospects of combating the problem.

It is incumbent on government to reinforce understanding of the relationship between serious crime, the business world and the states legislative reaction to it. Systemic thinking can help develop a greater understanding of this relationship and provide possible policy designs that balance effective action within the constraints of the anti trust, free trade, individualistic capitalism that is characteristic of the political and economic outlook of the UK and the USA (Riley 1994; Weidenbaum 1975). It is consistent with this underlying philosophy that we try and avoid regulation, and if a better understanding of the fraud process helps with this it is likely to be more acceptable to both government and business policy makers

Policy Design within Legal, Economic and Political Constraints

We should undertake any "holistic" systemic understanding exercise linked to potential policy design with some trepidation because it has to deal with political, economic and legal issues. The approach adopted is to emphasize Soft Systems Methodology (Checkland 1987; Richardson Wolstenholme and Morecroft 1994). Further understanding of problems seen in isolation from politics and the jurisprudence of the legal process are likely to have little impact on government initiatives towards fraud. This is all too apparent in the United Kingdom. It is acknowledged that business fraud is a serious problem and as such it is a political and economic issue. It is not a case simply of what can be done, but whether it is politically acceptable (Levi 1993). Three strands of proposed reform in the UK to deal with fraud during the 1980's were all controversial. Interventions proposed included,

- . removal of jury trial (to speed up trials and increase effectiveness at the trial stage).
- . development of administrative solutions (further regulatory agencies).
- . increased auditors powers and improved corporate governance (to help with compliance and investigation).

All were and are constrained by a right wing political agenda and more fundamentally a philosophy of non interference and rights discourse. This is a characteristic of the UK and USA, where there is an emphasis on de regulation and non interference. Any "solution" must be considered in this context. It means that efficiency and effectiveness are not the only values within which to design and interpret policy, account must also be taken of justice, deserts and equality (Dworkin 1986). This has resulted in criticism of the law and economics movement (Stigler 1992) and generally questions the meaning of "effectiveness" and law (Allott 1980, ch.1). It makes the evaluation of "success" a complex issue involving the balancing of values. The importance of this cannot be over emphasized especially the closer a compliance regulation looks like a criminal sanction and individual liberty is involved.

This leads to a further constraint. The dominant political and economic perspective is based upon a laissez faire premise that regulation is bad for business. It follows that non interference as a political and economic belief again mitigates against or at least constrains planning. There is an obvious tension between the role of the state as protector of the public interest and its relationship with business and commerce.

This paper takes a middle course which emphasizes a public philosophy (Lippmann 1955) and the values of an "Open Society" (Popper 1962). The latter believed in only "piecemeal social engineering". He produced a possible problem solving methodology and its great strength was in linking it to a rights discourse and fundamental belief in individual freedom. Popper recognised the role of politics in controlling what he called "the demons", of economic power, but action is constrained by the fundamental paradox of freedom and of state planning which is that, "if we plan too much, if we give too much power to the state, then freedom will be lost, and that will be the end of planning" (Popper 1963, 128). There is room for what Popper calls "situational logic", but the analysis of problem solving is constrained by methodological rigour and the paradox of freedom.

This paper has placed powerful constraints on piecemeal solutions but this should not prevent holistic systemic understanding and its careful application to real world problems. The difficulty in the UK is that non interference and individualism seems to associate understanding with intervention. Governments can impose regulatory sanctions, but can also develop the necessary understanding of "fraud" which in the long run it may in fact prevent the need for regulation and draconian invasive law.

The Fraud Problem and application of Systemic Thinking

The continued repetition of serious frauds means that governments have to consider appropriate responses. Part of the problem as seen by Popper and in particular Hayeks' scientific subjectivism is the fragmentation of knowledge (Vlieghe 1994). In this sense system dynamics and computer modelling may assist. There are several reasons why we should consider this further. It may help with a broader holistic understanding of how fraud acts as a form of financial pollution causing damage to the integrity of markets and the mechanics of how it is perpetrated. Secondly it may allow the development of more sophisticated models of effectiveness and evaluation based on variables outside those normally associated with a context specific compliance regime. Thirdly, it may help in improving understanding and in recognising mutual interests and cooperation between business and government. This is building upon what the compliance literature calls "Tripartism" (Braithwaite 1992). All interlink and each are now considered in turn:

Fraud as Pollution

In the UK the criminal law struggles with the problem of fraud as do the law enforcement agencies associated with it. There is a considerable literature on policy design and implementation outside fraud in the area of environment and it takes us closer to our perspective which is fraud as a form of pollution. It becomes an issue within business and society. This conference theme is Soft Landing into the 21st Century: Sustainable Development and Environment. There is a well evolved understanding of the relationship between public and private interests, business accountability and making the polluter accountable. Fraud has similar characteristics. It is global, pollutes the integrity of markets and commercial confidence. It can lead to unfair competition, and massive disruption of individual and corporate property rights. Indicative of studies in this area is recent comparative research in Japan and the USA into High Tech industries, and environmental damage (Yoshida 1994) which outlined three important stages in response:

- . Environmental Protection Movement.
- . Control by Government.
- . Cleanup by business.

Such an approach has to confront the various socio economic factors already outlined and follows a similar method to other countries because the environment is a global issue. It requires identification of common interests and much of the analysis of process, together with cause and effect, including the reference to High Tech are similar to those presented in a more unstructured way in the fraud debate in the UK. The process of control is similar, fraud is "High Tech" and a problem which effects the financial environment. It has become a public policy issue. The problems are similar but solutions further constrained by politics, and the need to allow business to operate without undue restriction.

A Problem with efficiency, quantitative and qualitative analysis

Secondly whilst we may have difficulties in quantifying effectiveness it may be possible to consider this complex area and accommodate counter intuitive factors (Hubin 1994).

It has been pointed out that any form of regulation (criminal sanctions are an extreme example) should be a last resort. Of course it is sometimes vital. A powerful political tool in the hands of non interventionists is that there are difficulties measuring the effectiveness of regulation, and the use of criminal sanctions against business. The compliance literature contains analysis of the motivation of companies and the effectiveness of different compliance strategies. This area has been considered in system dynamics (Jacobsen and Bronson 1985; Wolstenholme 1990). In a study based on norm evasion Jacobsen and Bronson consider a sociological theory and its dynamics by simulation through stages from the establishment of system variables, causal loop diagrams to rate level diagrams. This paper does not adopt a sociological approach but acknowledge the importance of this work in the area of compliance and deterrence theory. The focus of this paper is on policy design, in the areas identified by Jacobsen and Bronson in their rate level diagram as autonomous control (AUTCON) and informal control (INFCON) in the hope that it will avoid or contain a third variable formal control (FORCON).

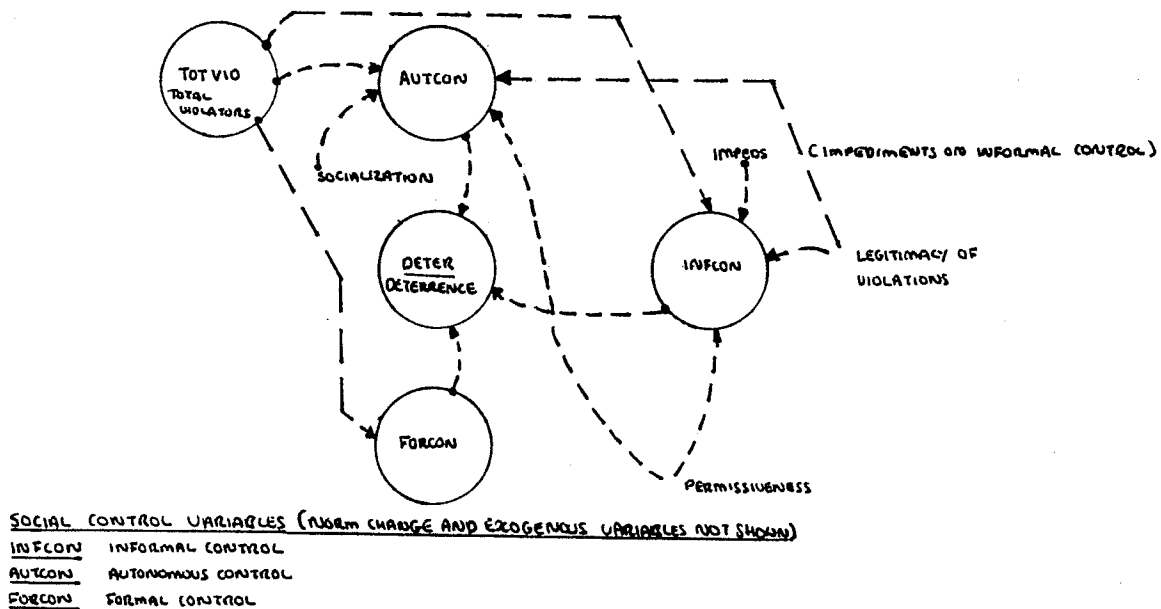


Figure 1. Jacobsen and Bronson (p 119), Influence of social control variables.

Braithwaites Tripartism

In compliance theory corporations are regarded as "amoral calculators", "political citizens" or "incompetent organizations". There are doubts about recourse to the "moral calculus" of Bentham and a simple cost/benefit analysis of a corporations obligations (Hubin 1994). According to these theories there may be a mix of compliance and deterrence, with different emphasis on persuasion, insistence, education and sanctions.

However there is emerging dissatisfaction about traditional right based deontological theory and talk about the common interests of business and government. Braithwaite introduces the concept of "tripartism" and the evolution of co operation, in an effort to "transcend the intellectual stalemate between those who favour strong state regulation of business and those who advocate deregulation" (Braithwaite 1992, 3).

Braithwaite looks at competing deterrence and compliance models of regulation and the efficacy of tit-for-tat (TFT) enforcement. However it is recognized that the preferred option is industrial self regulation because it is the least burdensome. Of course if we have a crisis such as the UK pensions industry then we are too late with our initial purpose of trying to prevent regulation and then should consider how the application of our initial method may make industry more compliant and whether system dynamics can add to compliance and deterrent theories.

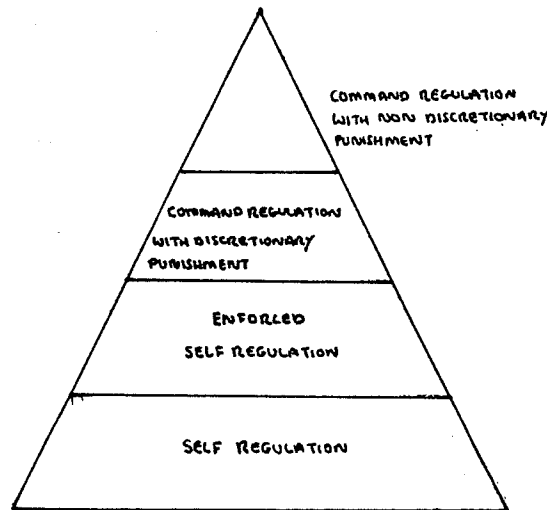


Figure 2. Braithwaites Pyramid of Regulatory Strategies (p 39)

Maxwell Affair, Effect on the Pensions Industry and Government Response

A classic example of a cause (alleged fraud) and effect (further regulation) process is the Maxwell affair which has led to proposals for reform of the UK pensions industry. It has been estimated that the loss caused to the pension funds is in the region of £453 million. It is alleged that money and other assets were siphoned out of a common investment fund and other pension schemes (see fig 3) in order to support over 400 private companies, controlled by Robert Maxwell which were all accumulating huge debts (Goode Report 1993). The Goode Report noted a lack of a proper legal framework, lack of integration of statutory provision and in the associated Research Findings (Vol 2 of the Report) a

massive loss in confidence in the Industry. In advance of the proposed reforms (fig 4) there is already bitter recrimination from pensioners who have lost money and the industry which resents further regulation.

Three different regulatory bodies had responsibility for various parts of the industry. None had overall responsibility. In order to perpetrate the alleged fraud, fraudulent transactions cut across business and professional organizational boundaries, each regulator only seeing a part of the suspect transactions through their own perceptions. In systemic terms through lenses and filters (Morecroft 1985).

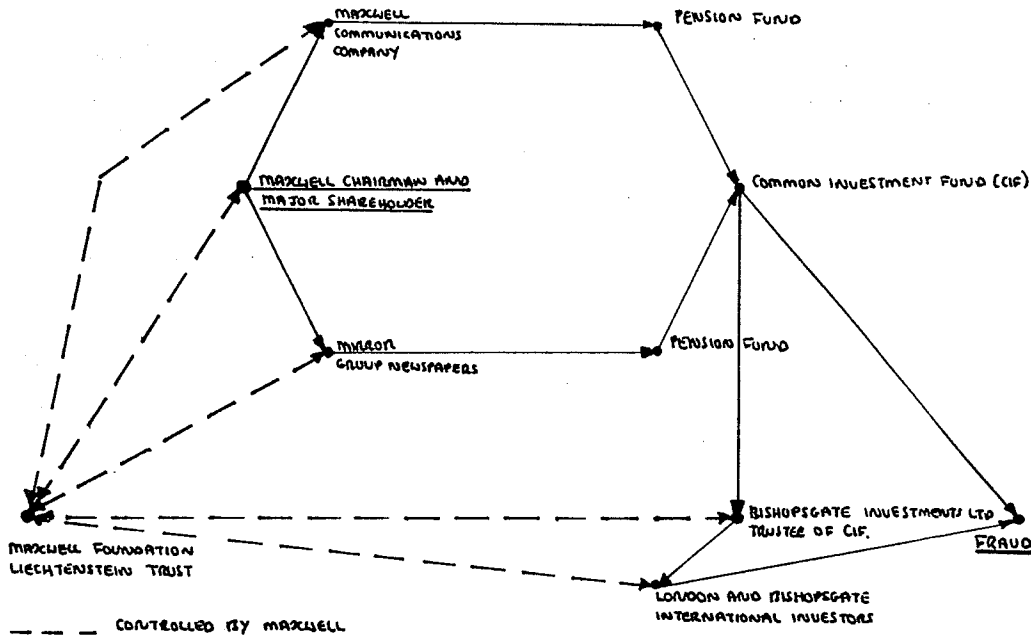


Figure 3. Alleged Maxwell Pension Industry Fraud

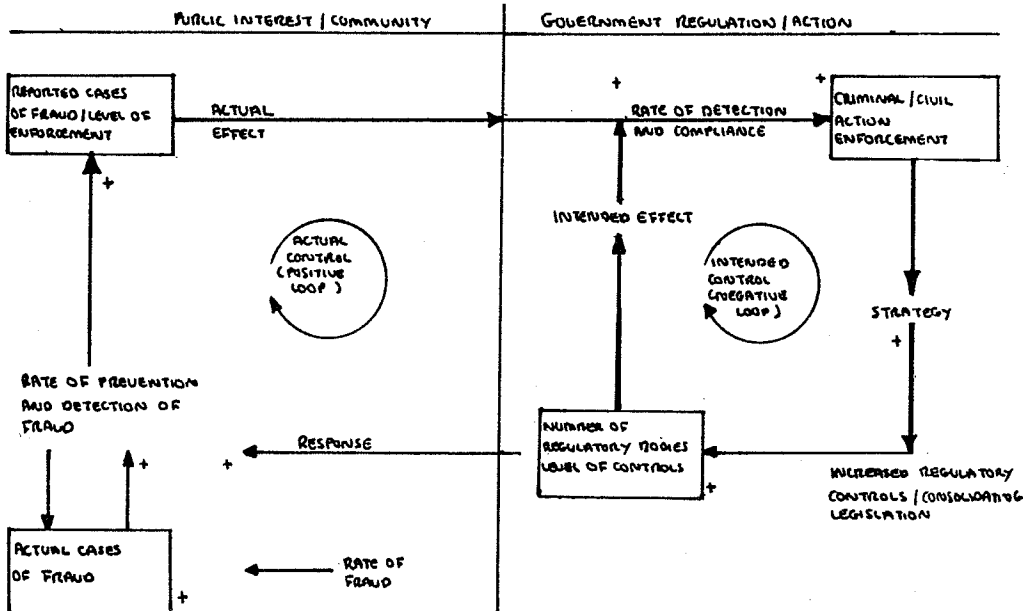


Figure 4. Expected Counter Intuitive Effect of Regulatory Response

Some reflections on the limitations and problems of regulation

1. In the pensions industry the need for reform was motivated by a massive alleged fraud. It is possible that it would have occurred whatever the regulatory structure. What was in place divided responsibility and perception of the fraud problem. The proposals for reform improve the regulatory structure and consolidate pensions legislation, but responsibility for regulation remains split. Fraud crosses these regulatory boundaries. The industry complains and argues that profitability will be effected. Public confidence is badly damaged.

2. The second point is that we should be cautious about techniques claiming to measure efficiency and effectiveness of regulatory agencies. The counter intuitive model (fig 4) indicates the complexity of this issue. The compliance literature contains many studies on regulation and deterrence, but once we introduce the wider issue of fraud as a community problem and introduce criminal justice values it should be considered in a wider context.

3. In addition quite separately the UK Government in the 1993 Criminal Justice Act and Money Laundering Regulations introduced wide scale obligations on business and professionals to report suspicions of money laundering and made it a criminal offence to assist another to retain the benefit of criminal conduct including fraud. These laws are deeply unpopular in the business community and are considered to be a serious blow to the concept of banking confidence and of confidentiality within and between financial institutions. It should be recognised that these are in addition to business regulation and are designed to obtain information. It is also apparent that often business is directly and indirectly a victim.

4. If we follow Popper then we should acknowledge that whilst regulation may be necessary, we should be cautious about claims for its effectiveness and take very seriously the price. The price in this context includes dominant political, legal and economic constraints, causing, in no particular order interference with legal rights, loss of freedom to trade, reduction in business profitability, cost of enforcement and inadequate claims concerning effectiveness. Once we have crossed the rubicon with piecemeal control replaced by consolidated context specific regulation then we move to the second level of Braithwaites pyramid (fig 2). It should be remembered that it was fraud that provided the catalyst for this change.

A Cooperative Framework based on Systemic Thinking

Systemic thinking enables us to understand is a wider holistic perspective on the issue of fraud as an environmental issue and the limitations on claims to deal with it. These themselves are powerful tools in policy design because they introduce methodological rigour and realistic expectations. In this paper it is proposed to limit further consideration to the base section of Braithwaites pyramid.

If we accept a common interest and the problem of fraud we have the start for constructing models which identify the fraud process and provide information feedbacks underlying the roles of all involved. It in effect broadens our understanding of the base. This provides an alternative tier of responses which are conceptualized against the limitations of a regulatory strategy. Such an approach requires a role for government in terms of facilitating awareness. It will not do to simply hive off responsibility in the form of either regulatory or self regulatory bodies as they may not have the capacity to see a broader picture. Businesses should be encouraged to move beyond stakeholder

theory and traditional risk analysis. They cannot be complacent. Recent legislation in the UK makes a failure to report suspicious financial dealings (which may be associated with the fraud process) a criminal offence. Corporations should understand the problem of fraud as an environmental issue, recognise its cost and accept the need for active control and self regulation, perceived as a common good, so as to forestall the inevitable cyclic slide into further regulation. Before we can expect business to do this government policy makers must overcome ideological barriers, institutionalize the problem, understand the integrated nature of the way the business medium facilitates fraud through process analysis and design broad policy initiatives developing strategy that is capable of verification and evaluation.

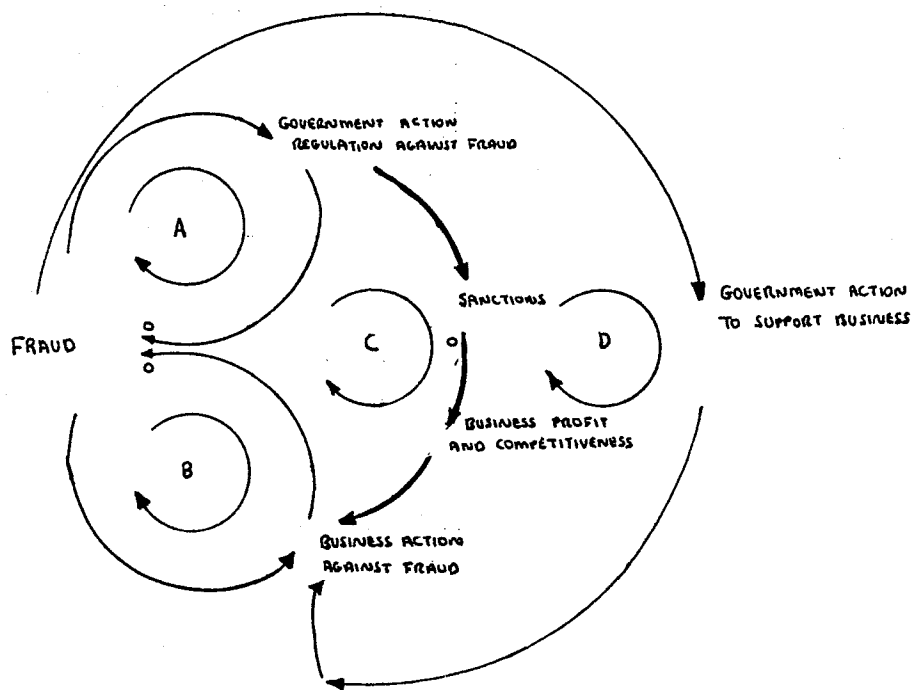


Figure 5. Causal Loop Diagram of Government/Industry relationship

- A. Government action to control fraud, regulation, compliance or and criminal sanctions, (balancing loop).**
- B. Business action to control fraud, (balancing loop).**
- C. Government action effecting business freedom and profit. Business incentive to fight fraud reduced, fraud worsens, (re inforcing loop).**
- D. Better government action to control fraud by supporting business action, (balancing loop).**

Government policy design

Systemic thinking helps with the development of models that form the basis of public policy design. It should be "holistic" and based on soft modelling techniques which will help identify the fraud "process" seeking to establish how it is committed across organizational boundaries and associated with commercial transactions. They can also assist with understanding the dynamic complexity of both

Parallel Program

business and regulatory organizations. Further understanding of the fraud problem, by government can translate into policy design which encourages business to take positive action for the public good. It enables policy makers to take an institutional perspective and possibly to develop minimum interference models from maximum information. It can positively avoid regulation by pointing to problems in evaluating effectiveness and also provide persuasive arguments to business to share information and develop further more sophisticated counter measures.

Company policy design

A company may already use risk management and forensic accounting to deal with fraud. They may also spend substantial sums on compliance. It is also possible that they have altruistic motives and an enlightened concept of stakeholders. They should remember however that they operate in a High Tech environment which may facilitate fraud and make it difficult to detect. The legal fact of incorporation itself can encourage fraud and makes it difficult to detect. Further government regulation may well attack business confidentiality and professional integrity. If business wants to avoid further slides in this direction as government reacts to fraud by legislating, then they must have a recognition of a public philosophy. KPMG Peat Marwick produce advice on the prevention and detection of fraud (Huntington 1992). This type of self help is useful however it cannot be expected of itself to provide information about fraud across boundaries and beyond traditional parameters of company thinking. Intermediate bodies such as trade associations and regulatory bodies may provide a broader perspective however ultimately there is a need to institutionalize understanding if not responsibility and this cannot be expected unless governments develop a "culture of understanding and problem solving" within which business can design effective anti fraud strategies.

Conclusions

Recent legislation in the UK, introduced or planned in response to the fraud problem, has re-inforced the rhetoric of compliance and regulation with that of the criminal law. These are deeply unpopular and divisive in the financial sector. They effect business confidentiality and inevitably compliance costs. In addition they increase bureaucracy but conversely may lead to under funded agencies and a gap between law "in the books" and "law in action". They can only be avoided or constrained if the industry "cleans up" and designs appropriate checks. The problem is that traditional stakeholder theory driving business reaction will not necessarily provide an adequate response. The issue of fraud require a broader perspective which includes an understanding of the fraud process and its links with banks and professionals and how as a problem it cuts across different organizational boundaries. This may be a development on existing perceptions because it provides for the isolation of mutual interests as forming the basis of integrated policy responses. It requires the government to take an active role in facilitating understanding and requiring co-operation.

As we have seen recently with the Baring Bank collapse no amount of government or industrial regulation can be guaranteed to prevent a crisis occurring. On the other hand a better understanding of the dynamics of the problem will help public confidence and may prevent radical solutions. It requires business to accept this role, which a priori requires a strong commitment from government, who should distinguish holistic understanding from interference.

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