

The Long Arm of Crime and Financial Crisis

Alain Bauer

Starting with the "Yakuza recession" of the 1980s, then the U.S. Savings and Loans Crisis of the same era, followed by Mexico, Russia, and Thailand, a series of financial crises with a more or less marked criminal dimension has rocked the world's leading countries over the last 30 years. Central regulators paid no attention to this phenomenon despite International Monetary Fund (IMF) estimates of a quantity of dirty cash of between 1% and 5% of world gross domestic product (GDP). The world of crime has become a financier of primary importance.

The Savings and Loans Hold Up

The Savings and Loans Crisis devastated U.S. savings associations in the 1980s. Almost two thirds of these institutions went out of business through bankruptcies that were clearly fraudulent. The crisis is estimated to have cost around US\$160 billion, US\$124.6 billion of which was doled out by the U.S. Treasury, a cost equivalent to World War II.¹

Jean-François Gayraud reminds us that, according to the U.S. General Accounting Office (the federal accounts auditing body) and to the numerous judicial, university, and journalistic investigations conducted since, these bankruptcies resulted from

massive and systematic misappropriations carried out from inside the savings associations themselves by senior executives (white collar crime), sometimes in association with members of traditional gangland groups.

Effective governance of these "thrift" associations had become lax. The Garn-St Germain Depository Institutions Act 1982 had deregulated the sector regardless of its particular sensitivity to criminal ambitions. Local Mafias leapt into the breach. Based on falsified documents, an increasing number of loans at very low interest rates were granted to "friends" on very "flexible" terms and conditions. At the same time, a systematic use of "creative" accounting concealed the colossal losses. In 1987, the U.S. Attorney General acknowledged massive frauds.

The vast majority of the ill-gotten gains raked in by the fraudsters were secreted away into tax havens. It also led to the collapse of the U.S. construction market, which fell from 1.8 million new homes per year to only 1 million between 1986 and 1991.

"Yakuza Recession"²

The Japanese "Yakusa" are some of the most powerful organized crime organizations. In 2008, there were nearly 90,000 members amalgamated into

¹ On this crisis see (in French) Jean-François Gayraud, "*Crises Financières: la Dimension Criminelle*" (Financial Crises, the Criminal Dimension), *Défense Nationale et Sécurité Collective*, December 2008; Jean-François Gayraud, "*La Dimension Criminelle de la Crise des Subprimes*" (The Criminal Dimension in the Subprime Crisis), *Diplomatie*, Special Edition No. 8, April-May 2009 and (in English) Kitty Calavita, Henry N. Pontell, and Robert H. Tillman, "*Big Money Crime, Fraud and Politics in the Savings and Loan Crisis*", University of California Press, 1997.

² On this crisis see Jean-François Gayraud, "*Le Monde des Mafias, Géopolitique du Crime Organisé*" (The Mafia World, Geopolitics of Organized Crime) (Odile Jacob, 2005 and 2008); Jean-François Gayraud, *Crises Financières: la Dimension Criminelle* (Financial Crises, the Criminal Dimension), *Défense Nationale et Sécurité Collective*, December 2008.

three leading criminal federations (Inagawa kai, Yamaguchi Gumi, and Sumiyoshi Ren-go). These organizations are involved in the usual array of crimes: racketeering and protection, arms trafficking, prostitution, pornography, illegal gaming (Pachinko), and merchandise smuggling.

During the 1980s, the "Jusen" (real estate lending cooperatives) were frequent victims of falsified loans, many of which were applied for by companies "reeking" of Yakuza involvement. According to the Japanese government, in 1999 alone, more than 40% of loans to finance construction found themselves in the hands of organized crime syndicates. In 2002, it was estimated that there were still "bad loans" (Mafia loans, for the most part) valued at between US\$800 and US\$1600 billion. According to Japan's national police force, around half of these "bad loans" were non-recoverable as they were held by organized crime. Goldman Sachs confirmed the estimate in relation to business loans. According to the TV channel, NHK, two in five Japanese companies had Yakuza links. After inflating the market, the Yakuza bought up real estate assets at slashed prices and forcibly blocked settlement of the liabilities of some companies. The rare bankers who dared to intervene were threatened and, in some cases, murdered.

The extraordinary duration of the Japanese financial crisis, despite the many and far-reaching recovery measures, can only be understood if the criminal dimension is included in the equation. The Yakuza caused companies to absorb losses from the unpaid loans and then privatized Mafia profits.

The country has still not recovered.

"The Collape of the Russia House"³

The transition to a market economy in the Russian Federation began at the end of 1991. In 1992, Russia launched a massive privatization program. "Shock therapy" began in 1994 with 50% of the public sector organizations (i.e., more than 100,000 State enterprises) being privatized. This fast-paced deregulation of the economy was conducted in highly questionable circumstances.

The privatizations and control over raw materials for the most part benefitted businessmen with close connections to the Leadership. The country witnessed a grabbing of public assets, monopolized by a group of cronies. These new "robber barons" acquired notoriety and became known as the "oligarchs". These profiteers, sometimes backed by a criminal underworld in full revival, realized that their situation was precarious and invested their ill-gotten gains abroad in tax and banking havens.

Through these "hasty" privatizations, the transition initially caused the GDP to halve. Unemployment, at a rate of less than 0.1% of the working population at the start of the 1990s, rose to 7.5% in 1994. At the same time, according to the Lancet (2009), the mortality rate increased four times faster in Russia than in other benchmark countries.

The economic depression culminated in the financial crisis of 1998, marked by sharp devaluation in the rouble and a sovereign debt default. The flight of capital via criminal activity during this period is estimated at US\$100 billion.

A large portion of the funds injected into the country's economy by international institutions such as the IMF and the

³ On this transition see Joseph Stiglitz, "*Quand le Capitalisme Perd la Tête*" (When Capitalism Loses its Head) (Fayard 2003); Joseph Stiglitz, *La Grande Désillusion* (Globalization and its Discontents) (Fayard 2002).

World Bank to save it from the damaging effects of the "shock therapy" was diverted and placed outside Russia.

"The Tequila Crisis" 1994

The 1994–1995 Mexican financial crisis, known as the "Tequila Effect" was, more than anything, a "cocaine effect". Mexican traffickers acquired a very large share in the revenues from Colombian drugs exported to the United States at the beginning of the 1990s, earning themselves more than US\$10 billion per year. The business privatizations under the Salinas presidency (1988–1994) provided an opportunity for "recycling" the profits from narcotics through a banking sector that had itself been privatized. Following the 1994–1995 crisis, the banks owed more than US\$180 billion for which the State Treasury was forced to assume liability.

Combined with an influx of international capital, this money laundering contributed to a massive injection of enormous sums of cash into the economy and the creation of a double real estate and stock market "bubble". Although they represented only 1% to 3% of Mexican GDP in the beginning, both in trade and in banking, the narcotics dollars distorted markets in favor of Mafia networks. The "money laundering premium" earned by the drugs barons made them more competitive and able to "absorb" their competitors and yet still focus on short-term speculative investments. Access to credit enabled them to recycle dirty capital and to increase the

power of its impact. The injection of narcotics dollars weakened trade and precipitated payment defaults, causing the Peso to be devalued and bringing on the financial crisis. It cost the Mexican Treasury more than US\$100 billion and increased unemployment threefold.

"The Thai Bubble"

The 1997 Asian Crisis started in Thailand, where the scenario was a similar one. The equivalent of 10% of Thai GDP was controlled by organized crime networks which earned their income for the most part from illegal gaming, prostitution, and trafficking in drugs exported from Burma. As in Mexico, the influx of short-term foreign capital accelerated a speculative trend. The deterioration in external accounts made worse by the increase in the value of the US dollar and shrinkage of export opportunities precipitated the devaluation of the Baht.

However, the local political and financial system also played a role by massively encouraging the laundering of illegal and Mafia earnings. At the end of 1999, despite a 10% fall in Thai GDP in 1998 and real estate overcapacity in Bangkok estimated at more than three hundred thousand units, sales prices held their ground. The reason for this stability, impossible to comprehend in market terms, becomes clear if we consider the money laundering circuit impact.

⁴ On this crisis see a number of articles by Jean-François Gayraud: "La Dimension Criminelle de la Crise des Subprimes (The Criminal Dimension of the Subprime Crisis), *Diplomatie*, Special Edition No. 8, April–May 2009; "Crises Financières: la Dimension Criminelle Un An Après" (Financial Crises, the Criminal Dimension One year On), *Défense Nationale et Sécurité Collective*, December 2009; "Capitalisme Criminel: Subprimes ou Subcrimes?" (Criminal Capitalism: Subprime or Subcrime?), *Cité*, No. 41, PUF, March 2010.

⁵ See Noël Pons, "La Crise des Subprimes: une Aubaine pour les Criminalités?" (Subprime Crisis: A Bonanza for Criminals), *Cahiers de la Sécurité*, No. 7, January–March 2009.

"The Subprime Tsunami"⁴

As highlighted by the expert, Noël Pons⁵, the mechanics of the crisis that broke out in 2009 were almost identical to that of the 1980s. Only the parties involved were different. In this new format, the banks were fed with applications for loans by mortgage brokers who made lavish promises. A number of applications were discreetly categorized as "non-documented". They were in fact faked, involving acts of fraud, scamming, abuse of trust, and forgery. Operating with the backing of mortgage lenders, the brokers dispensed questionable loans, using predatory lending techniques, consisting of lending to people from vulnerable demographic groups (poor people, ethnic minorities, etc.). Credit frequently exceeded 125% of the value of the home purchased with the loan. Home values were also significantly inflated. Loans were frequently made to borrowers unable to meet capital repayments on an interest only basis, a system thriving only in conditions of speculation. The illusion persists as long as the market is still rising. The entire economy, steeped in debt, became a "pyramid economy", a gigantic Ponzi scheme.

In an attempt to conceal what was really happening, the banks tried amalgamating loans into common pools by "securitizing" them and then, in the second stage, mixing the "junk" securities with others in global structures, themselves overvalued, to produce a cocktail of fund derivatives based on nothing, but still highly speculative. Naturally, accounts were also falsified or externalized. In the third stage, the "globalized" structures were insured and then reinsured and finally sold to "investors", many of whom were domiciled in tax havens. These on-sold "receivables" were then used as leverage to raise loans from the major commercial banks that placed these

"virtual securities" with other, notably foreign, banks, local authorities, associations, etc. From the bottom of the ladder upwards, these dealings may not always have been blatantly fraudulent but were at least often very shady.

A few months before the outbreak of the subprime crisis, although nothing could be done to prevent it, Michael Mukasey, Attorney General in the George W. Bush administration, curiously denounced the criminalization of the economic and financial markets on April 23, 2008, at a conference on organized crime at the Center for Strategic and International Studies (CSIS).

More recently in Europe, there was the case of *the carbon VAT scam which involved buying rights to pollute, exclusive of VAT, in one European country through a dummy or shell company, with almost immediate resale on the French, English, or Italian markets, inclusive of VAT. The fraudsters pocket the VAT rate differential and disperse it between offshore accounts.*

These transactions involve the fraudsters themselves, their protectors, and financiers, especially the "launderers" of the monies earned from trafficking, including in narcotics. A judge was reported in the newspaper "Le Parisian" as saying that *"there is a veritable Mafia behind the carbon emissions tax and a Mafia does not hesitate to kill."*

In January 2009, Serge Lepage, son of a well-known underground figure, was shot down in front of his home. It was suspected that he had been called upon as a provider of funding for carbon emission tax fraudsters.

Amar Azzoug was executed on April 30, 2010, in a brasserie in Saint-Mandé. A known former bank robber, this 35-year-old man had been implicated in carbon tax fraud and its embezzled millions. He had known that he was a marked man and

had alerted the police, incriminating Samy Souied as the probable person behind the threats.

Five months later, Samy Souied himself was shot down by two men in front of the Palais des Congrès at Porte Maillot in Paris. He had just landed from Tel Aviv and was due to leave again that same evening. He was carrying €300,000 in cash. The last man who had spoken to him was the former son-in-law of Claude Dray, a hugely-wealthy businessman and art collector, murdered at his mansion house in Neuilly-sur-Seine on the night of October 24/25, 2011.

There was nothing that seemingly connected this murder with the previous ones. However, his assassination does raise questions: his safe was full of jewels and other valuables but nothing was stolen.

The real gangland bosses are concealed behind these "white collar" swindlers and fraudsters. These men do not forgive errors or oversights. Similarly, the "loveable rogues" of old were not inclined to forgive, and the amounts of money at stake explain this epidemic of old-fashioned 7.65 mm weapon murders.

At the beginning of February 2012, the French Court of Auditors covered this affair in its annual report. It stated "*the carbon emission quota VAT fraud is the largest tax fraud ever recorded in France in so short a time. It demonstrates failings in regulating a market in which naivety about how resourceful fraudsters can be combines with risk perception errors on the part of market administrators and government. It also highlights the inadequacy in forward planning to provide effective regulation tools for markets in which, given their characteristics, the fraud potential has been overlooked.*"

The Court of Auditors assessed the tax loss to the French autumn 2008 to June 2009 budget at €1.6 billion. Europol estimated

the total loss within the European Union at €5 billion. Twenty or so prosecutions have now been brought involving more than a hundred individuals.

"Neither the European Commission nor Member States have shown any concern for safeguarding the conditions in which the VAT is collected", stated the Court, which underscored "*the original flaws and loopholes in the system: almost unrestricted access by any natural person or corporate entity to national quota registers and the lack of external regulation.*" It also criticized the "*inadequate vigilance on the part of the market administrator, too superficial an applicant identity checking process, unconvincing application of duties of vigilance, market operators perceived the systemic magnitude of the fraud too late, errors and mismanagement on the part of finance ministries.*" On the subject of TRACFIN, the French financial intelligence unit, the Court of Auditors noted "*data processing delays incompatible with swift action to stop fraud*". It also criticized the General Directorate for Public Finance for failing to "*anticipate*" the magnitude of the fraud, stressing that "*its standard procedures were not fit for purpose*" and "*there was inadequate coordination between its different services.*"

Despite acknowledging the May 2009 decision by the Finance Ministry to alter the VAT collection method on CO2 quota transactions to stem Treasury losses, the Court of Auditors reiterated the point that there were still "*persistent problems, especially of poor*" or inadequate control of access to registers.

In short, as usual, the commission of enquiry only exposed what had been known for a long time (the first frauds of this type date back to the 1970s): slow-moving and cumbersome regulatory authority action; existing systems incapable of taking the criminal dimension into account.

Criminal organizations started on a small-scale to test the market, just a few hundred thousand francs to begin with. Yet, they have managed to steal several billion euros with 40 years of practical experience, like the Ponzi schemes that will soon celebrate a century of existence, and which still seem as effective as ever. What will the next stage be?